PRODUCT INNOVATIONS: BANKS RESPONSE TO THE FINANCIAL LIBERALISATION IN KENYA

BY
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A Project Submitted to the School of Business in Partial Fulfillment of the Requirement of the Masters Degree in Business Administration.

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FALL, 2001
STUDENT'S DECLARATION

I, the undersigned declare that this is my original work and has not been submitted to any College, Institution or University other than the USIU in Nairobi for academic credit.

Signed

Date 08th October 2001

Joyce Leiyan.

This project paper has been presented for examination with my approval as the appointed supervisor.

Signed

Date

Dr. Kinandu Muragu.

Signed

Date 25th January 2002

Dean, School of Business

Signed

Date 1st February 2002

Deputy Vice Chancellor, Academic Affairs
DEDICATION

This project is dedicated to my parents, Joseph and Elizabeth Leiyan Motong'o, for their great sacrifice in ensuring that I got a head start in life. And to my husband, Ian Thairo Ng’ethe, without whose tireless encouragement and faith this project would not have become a reality.
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acknowledgements</td>
<td>(i)</td>
</tr>
<tr>
<td>List of Tables and Graphs</td>
<td>(ii)</td>
</tr>
<tr>
<td>List of Abbreviations</td>
<td>(iii)</td>
</tr>
<tr>
<td>ABSTRACT</td>
<td>(iv)</td>
</tr>
<tr>
<td>CHAPTER ONE: INTRODUCTION</td>
<td></td>
</tr>
<tr>
<td>1.1 Background of the Study</td>
<td>2</td>
</tr>
<tr>
<td>1.1.1 Effects of the Financial Liberalisation on Banks</td>
<td>3</td>
</tr>
<tr>
<td>1.1.2 Response by Banks</td>
<td>4</td>
</tr>
<tr>
<td>1.1.3 Bank Innovations</td>
<td>4</td>
</tr>
<tr>
<td>1.2 Objective of the Study</td>
<td>5</td>
</tr>
<tr>
<td>1.3 Justification of the Study</td>
<td>5</td>
</tr>
<tr>
<td>1.4 Significance of the Study</td>
<td>5</td>
</tr>
<tr>
<td>1.4.1 Commercial Banks</td>
<td>6</td>
</tr>
<tr>
<td>1.4.2 The Customer</td>
<td>6</td>
</tr>
<tr>
<td>1.4.3 The Central Bank</td>
<td>7</td>
</tr>
<tr>
<td>1.5 Organization of the Study</td>
<td>7</td>
</tr>
<tr>
<td>CHAPTER TWO: LITERATURE REVIEW</td>
<td></td>
</tr>
<tr>
<td>2.1 The Role Regulations in Financial Markets</td>
<td>9</td>
</tr>
<tr>
<td>2.1.1 The Rationale for Financial Regulations</td>
<td>9</td>
</tr>
<tr>
<td>2.1.2 Consequences of Financial Market Regulation</td>
<td>9</td>
</tr>
<tr>
<td>2.2 Economic Reform Measures</td>
<td>11</td>
</tr>
</tbody>
</table>
2.3. Impact of Financial Liberalisation on the Financial System .......... 13
2.4. Response by banks ........................................................................ 16
2.5. The Role of Information Technology ............................................. 18
2.6. Bank Innovations .......................................................................... 19

CHAPTER THREE: RESEARCH METHODOLOGY

3.1. Introduction .................................................................................. 22
3.2. Population and Period ................................................................... 22
3.3. Sample ........................................................................................... 22
3.4. Data Collection ................................................................................ 23
3.5. Data Analysis .................................................................................. 23

CHAPTER FOUR: RESULTS AND FINDINGS

4.1. Introduction .................................................................................. 24
4.2. Coverage ....................................................................................... 24
4.3. Analysis and Findings .................................................................... 24
    4.3.1. Banks Reactions to Government Policies ......................... 27
    4.3.2. Product Presence .................................................................. 30
    4.3.3. Market Share Command ....................................................... 33

CHAPTER FIVE: CONCLUSION, RECOMMENDATIONS AND LIMITATIONS

5.1. Conclusion ..................................................................................... 34
5.2. Recommendations .......................................................................... 34
5.3. Limitations ..................................................................................... 35
5.4. Suggestions for Further Research ................................................ 35
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Third, the staff of some of the sample banks particularly Martin Oduor, George Ooko and Wilfred Michoma all of Barclays for sharing their insights into product innovations in the banking sector. Of equal importance is the management of National Industrial Credit Bank, notably James Mbatia who put me in touch with influential decision-makers in the banking industry.

This paper was not only the product of research but also that of my upbringing inclination. Indeed, my predisposition is a product of a lifetime. In this regard, I owe special thanks to my parents and husband who inculcated in me the intellectual restlessness that spurred me on in the academic field of which this project is a vital component. Finally, of paramount importance, was the grace, strength and patience accorded me by God during the entire span of the research. I am eternally grateful for His infinite support and love.

I however shoulder any errors of omission or commission such as may be contained in this research project.
LIST OF TABLES AND GRAPHS

TABLES:
Table 2.1 ....... NBFIs That Converted to Banks as at 31/12/96 ........................................ 15
Table 2.2 ....... NBFIs That Merged With Existing Banks as at 31/12/96 .......................... 16
Table 4.1 ....... Banks Reactions to Government Policies .................................................... 27
Table 4.2 ....... Product Presence ......................................................................................... 30

GRAPHS:
Graph 2.1 ....... Migration to the Banking Sector From the NBF1 Sector .......................... 17
Graph 2.2 ....... Bank Failures From 1987 to 1996 ................................................................. 17
Graph 4.1 ....... Product Market Share Command ................................................................. 33
**LIST OF ABBREVIATIONS**

1. **CBK** - Central Bank of Kenya  
2. **BBK** - Barclays Bank of Kenya  
3. **SCB** - Standard Chartered Bank  
4. **NBK** - National Bank of Kenya  
5. **KCB** - Kenya Commercial Bank  
7. **IT** - Information Technology  
8. **NBFI** - Non Banking Financial Institutions  
9. **SAP** - Structural Adjustment Programs  
10. **MNC** - Multinational Corporation  
11. **ATM** - Automated Teller Machine  
12. **EFT** - Electronic Funds Transfer  
13. **R&D** - Research and Development  
14. **CC** - Credit cards  
15. **DC** - Debit cards  
16. **IC** - Interest earning current accounts  
17. **HS** - High yielding savings accounts  
18. **FB** - Foreign exchange bureau  
19. **IMF** - International Monetary Fund.
ABSTRACT

In the last two decades, most Third World governments have been putting concerted efforts towards economic liberalization. In Kenya, the effects of the reforms constituting liberalization have in the most part disrupted previously predictable operating environments of most businesses. The banking sector has not been spared the brunt of financial liberalization and therefore has to grapple to survive within the settings of a liberalized economy.

This study seeks to investigate bank response to financial liberalization in Kenya with a specific emphasis on product innovation. These investigations were applied on a sample of four banks extracted from a total of fifty-four banks in Kenya as of 1997 based on certain defined criteria. Six of the major economic reform measures were applied and their effects, expected and actual reactions from the four sample banks analyzed by means of graphs and tabulation. Banks were expected to respond by creating products to counter the effects of financial liberalization.

The findings are that banks responded to financial liberalization by introducing appropriate products to deal with perceived threats and seize discerned opportunities such as were posed to market share and customer base.
CHAPTER ONE

INTRODUCTION

The banking industry holds a special place in the organised money market through its control over vast amounts of money held in deposits and advances. Banks access these amounts of money by offering attractive and lucrative vehicles of investment to the public. In the recent past, the number of investment vehicles available has greatly increased. This increase is matched by an increase in the number of commercial banks and hence the competition amongst banks to woo customers through the use of innovations.

Innovations, specifically as addressed in this paper, do not necessarily refer only to new products but rather, to both new and repackaged products. Repackaged products refer to pre-existing products which have been modified to be more attractive. Attractiveness in this case can either be by offering higher yields through higher investment interest rates or by being more convenient in way of lightening the customer’s burden e.g., credit cards ensure that one does not carry a lot of unnecessary liquid cash.

Sources of innovations vary in clarity especially in terms of their origination. Most innovations can be products of either or a combination of the following driving forces: technology, unexpected occurrences, process needs, market pressure or competition. These forces shall be addressed in more detail in the literature review. The most important thing to note about innovations is that they serve the primary purpose of differentiating between existing competitive products.

The liberalisation of the Kenyan economy as a whole spelt out major means of reform which would set the economic indicators such as interest rates free from major government intervention. In essence, financial liberalisation meant the deregulation of the financial market in a bid to revamp the Kenyan economy.
1.1 BACKGROUND OF THE STUDY:

Upon attainment of independence, Kenya adopted a development strategy that lay emphasis on strong public sector participation not only in the provision of public goods and services but also in banking and finance amongst others. This strategy served the country well in the first fifteen or so years of self-governance. Kenya did not go unscathed by the oil crisis of the 1970’s as well as other exogenous factors such as bad weather and deteriorating terms of trade. Gross mismanagement of public funds and resources, coupled with the huge unpaid debts, earned Kenya an unenviable deficit in its balance of payments. In the 80’s the seemingly indispensable donor community started exerting pressure on Kenya for economic reforms which were to be the criteria for the granting of the much-needed aid. The fruits of this pressure were bountiful and of differing variations. They included the infamous structural adjustment programs (SAPs). As defined by Dr. Ansu, SAPs are a series of inter related fiscal, monetary and institutional changes undertaken by a government to address the problem of poor economic performance. (Chief Executives Forum report August 1993, p. 11)

Some of the financial indicators that were to be deregulated under the SAPs included interest rates and foreign exchange rates amongst others.

Despite concerted efforts between the World Bank, International Monetary Fund (IMF) and the Kenyan government dating as far back as the early 80’s to reform the economy, liberalisation only took off in real earnest in the 1990’s. It is only in the ‘90’s that the Kenyan economy truly opened up.
1.1.1 Effects of the Financial Liberalisation on Banks

Given the new operating environment during this initial period of liberalisation, many banking and financial institutions have migrated from a state of mere complacency, to anxiety, to euphoria, to disillusionment and finally, to a state of reflection. The decade of the 90’s has indeed been a period of rapid changes hitherto unwitnessed. These changes were spurred by the legislative changes which stimulated far more inter-type competition within the financial industry. Participants in the financial sector have had to reflect and revisit their concepts, strategies and tactics in light of all these important changes.

The relaxation of foreign exchange controls and payment systems had a more or less direct positive impact on the banks. This is because banks could now offer foreign exchange based products without having to go through the Central Bank (CBK) as was the case before. Both the restructuring of weak financial institutions and the admission of new entrants resulted to the players in the banking industry increasing tremendously in number. This occurred as a result of some NBFIs having been acquired, converted to banks or merged with their parent banks. This increase was not devoid of some casualties. These included banks and NBFIs that failed to meet the required standards set by the Government through Central Bank. On the whole, the financial liberalisation had tremendous effects on the banking industry which acted as an eye opener to the respective players in light of the open market place.

The increase in the number of banks caused a major disruption to the market share possession. Prior to 1990 Barclays, Standard, Kenya Commercial Bank and National Bank jointly commanded more than 80% of the banking market in terms of branch network (presence), advances, deposits, clearing volume and value. By 1997, this oligopolistic structure had been notably disrupted and the market share dwindled to a combined possession of 58% - a reduction of 22%! Some of the new entrants in the market displayed a more customer oriented disposition which saw a significant exodus from the pre-existing banks to the new banks of customers mainly in the retail and small co-operate sectors. This movement was mainly because the banks not only met their own needs but more so those of the more enlightened public. For instance some of the new banks offered much higher rates of interest on deposits and thus gave bigger banks a run
for their money. Advances and deposits ceased to grow at the average rate of about 30% for advances and 35% for deposits and instead shrank to about 10% and 7% respectively.

1.1.2 Response by Banks.
The negative impact on the financial statements of the banks was certainly undesirable. However, there was initial confusion and ‘fumbling in the dark’ in this very important industry which was soon overtaken by a state of infatuation, with banks overcoming their initial reluctance and being particularly occupied with their newly defined roles as “competitive high street retailers”. Banks have had to reflect on their past strategies and decide as to whether these same strategies would help them sail through the heightened competition successfully. Revisiting of the strategic approach was critical for the achievement of market share and its subsequent retention.

Major amongst the banks responses were the following broad strategies: organisational restructuring, more intense customer service (in view of increased customer awareness), heavy investment in information technology (IT), research and development (R&D).

There being no increase in the size of the local market but having an increase in the number of competitors, the fight that ensued for some to retain and/or increase their market share and for others to attain a share of the scarce market was an unavoidable phenomenon. The players in the banking arena became haunted by the ‘market share possession’ element.

Indeed, the economic reforms set the mills of innovation grinding at high speed to enable banks keep afloat amidst high currents of changing environmental requirements.

1.1.3 Bank Innovations
Major amongst bank strategic responses was the innovation of new products and the repackaging of others – better known as finance retailing strategies. The main aim of this strategy was to ensure that respective banks either achieve or retain a sustainable competitive advantage.
1.2 OBJECTIVE OF THE STUDY:
It has been observed that financial liberalisation increased the number of players in the banking industry. This presented a threat to existing banks as it meant a distribution of the same market share amongst the increased number of banks. The objective of this study is to determine how the existing banks responded to the market challenge caused by financial liberalisation through product innovation.

1.3. JUSTIFICATION FOR THE STUDY:
The banking sector in most developing countries is characterised by oligopolistic structures which go hand in hand with over bearing government involvement. The players within these oligopolies are mainly banks within which the state has majority if not total share holding as well as subsidiaries of multinational co-operation. Some of these economies have not yet been liberalised and as such their financial and economic forecasts are quite predictable.

Kenya having only just stepped out of the above-described state is still in its ‘bottle feeding’ stage of liberalisation. The banking sector is still grappling with the new environment within which economic indicators are at the mercies of the market forces to a large extent. To date, there has not been any research done into the survival tactics employed by banks within the competitive arena in Kenya. Previous studies, not very much unlike this one, have been done concerning other sectors in the liberalisation of some economies in South East Asia. However, due to great similarities in structure between Kenya and other developing countries especially in Africa, this study into the use of product innovations as a means of combating the new threats will be significant in highlighting one of many responses of banks despite unique national attributes and implementation modes.

1.4. SIGNIFICANCE OF THE STUDY
Finance is by no means very important. It is therefore of paramount importance that the modes through which financial services are ‘engineered’, offered and marketed be thoroughly researched and scrutinised to ensure that they adequately serve the financial needs of both deficit and surplus units of capital.
It is intended that the execution of this study will be beneficial to the following interested parties, all of whom, through one way or another, produce and package financial products, scrutinise and supervise their implementation or consume the products.

1.4.1 Banks

These along with other financial institutions like NBFI's have a double role to play. First, they are the basic engineers of financial innovations. Second, they offer these products to the final consumers after discerning the need and matching it with the suitable financial product. Their aims and advantages include:

a) To woo customers.

Bank innovations are attractively packaged and as such woo customers. Apart from the customer who gravitates to a bank because of the attractiveness of a product, there are those customers who switch banks because the products offered end up saving a lot of time, frustrations and money. However, beside these two types of customers, there are those who associate bank innovations e.g., credit cards with prestige. Based on this misconceived notion, this type of customer will join a bank that provides these products.

b) To provide better and faster customer service.

The provision of better and faster service facilitated by the bank innovations makes it possible for there to be a win-win situation for both the customer and bank. Customers' benefit by getting faster service through shorter bank queues while banks deploy the newly freed human resources to other duties.

1.4.2 The Customer

Customers gain from a host of benefits offered by bank innovations. These benefits include: provision of safer and more convenient means of transactions, ensured safety of ones money in case of a robbery or accident, exact payments such as in the case of credit cards, reduction of the need for insurance and security escorts for large volume transactions, and reversibility of payments in the case of errors.

1.4.3 The Central Bank of Kenya

Innovations developed by banks cannot be implemented without the knowledge of CBK. It is however important to note that the Central Bank does not play the role of 'consent
given in this regard, but rather scrutinizes the credit line that each bank issuing products such as credit cards extends to its customers in total. This ensures that banks have control over their issued credit facilities through thorough screening of customers thus decreasing the rate of default. Banks therefore allocate adequate resources (money) to their bad debts accounts to cover for default amounts and non-performing accounts.

1.5. ORGANISATION OF THE STUDY:

This study is organised in form of chapters. Chapter Two contains the literature review of previous research findings and observations into the financial liberalisation and bank product innovations. Chapter Three constitutes the steps and details of the research methodology. The results and findings of this study are discussed in the fourth chapter which enumerates in detail the responses of the sample banks to the measures instituted as a result of the liberalisation. This study is concluded in the fifth chapter in which the recommendations, limitations and further research suggestions are presented.
CHAPTER TWO

LITERATURE REVIEW

The domestic financial sector in Kenya was accustomed to sailing through daily activities without much deviation from the norm but for a few 'predictable ripples'. The economic scenario at this time was characterised by mammoth monopoly, and the creation of an artificial environment through intense government intervention in the protection of the domestic industry. This calm and unexciting situation was not to last for long. Despite the Government's good intentions to protect the economy, Kenya was plunged into a whirlpool of economic regression. The Kenyan government along with the World Bank and IMF worked toward the implementation of economic reforms through structural adjustment. As the CBK governor, Micah Cheserem, said, "Structural adjustment becomes necessary when an economy is experiencing protracted stagnation, high inflation and difficulties in balancing its external obligations with its external receipts." (Monthly Economic Review, January 1995, p.2)

Through structural adjustment, the Government hoped to alleviate the twin problems of poverty and unemployment. In pursuit of a deeper purpose for SAPs the research team at CBK states that, "With the combined problems of low growth, high unemployment, negative real interest rates and overvalued currency, structural adjustment measures which, though very painful in the short-run, were required in order to restore equilibrium conditions and improve the long term economic gains." (Monthly Economic Review, April 1996, p.4). In this respect, financial liberalisation was aimed at shifting forward the gears of the economy vehicle by changing the rules of the game. At this point it was apparent that the regulations which governed the economic mechanism were not working as well as they previously did. The Government being the key regulator had to reflect on tactical changes to existing regulations.
2.1 The Role of Regulations in Financial Markets:
Regulation is the process of controlling a certain activity by rules or adjusting the workings of that activity to conform to specified requirements.

2.1.1 The Rationale for Financial Regulations:
Markets in general have been characterised as mechanisms which harness the pursuit of private gain to social ends. Foley emphasises the point of individual self-seeking gain by saying that, "...the self-interest that constitutes the main spring for markets to work will, if carried to extremes, produce effects which may undermine the market itself." (Foley 1991, p. 196)

The mainstay of regulations in financial markets and all other markets is justified in terms of protecting the less ‘sophisticated’ citizen from potential exploitation. As a result of various forms of ‘market manipulation’ monetary authorities along with other concerned bodies, e.g. governments, deemed it imperative to institute specific rules for regulating financial markets.

Most countries approach financial regulation in either of two major ways:

- A framework which places the responsibility for implementing, monitoring and enforcing standards on a legally constituted public body.
- A voluntaristic approach that relies primarily on self-regulation to carry out the same duties as those mentioned above within a broad legal framework.
  (Foley 1991, p.197)

2.1.2 Consequences of Financial Markets Regulations:

1. Stifling competition:
Regulations serve the unintended purpose of decreasing competition to a large extent. This occurs through the inability of many firms to meet the required standards to operate within the market. For example, when Co-operative Bank wanted to be listed in the Nairobi Stock Exchange as a bank, it was required to raise KShs. 75 million to be listed as a bank and not as a co-operative. On the same note, the requirement by CBK that all commercial banks and NBFI’s maintain 18% cash ratio
of total deposits held, resulted to most NBFI’s converting to banks and others merging with existing banks as this regulation made it difficult to survive in the NBFI sector which has fewer revenue inlets.

2. Increase in operating/transaction costs:
Those firms that must operate within the regulated market have to incur certain costs. These costs include the following:

   a) Resource costs:
   These costs are both direct and indirect. The direct costs are incurred as a result of the absorption of labour and capital costs by the regulatory agency to facilitate its proper function. On the other hand, the indirect costs are shouldered by the firms subject to the regulations. Through the process of compliance, demand is placed on management time and expertise which could have been more productively utilized to generate revenue from the market. The need to maintain specific capital requirements ties capital in forms which earn less than if the firm had a choice of other prudential ratios.

   b) Dynamic costs:
   These arise as a result of regulations inhibiting competition by way of forming ‘barriers to entry’. This unintended effect causes organisations to incur extra costs required to gain entry into the market.

3. Misapplication of resources:
A prudent investor is one who deploys resources to where returns are highest. However, regulations do sometimes result to misallocation of capital resources in a bid to ensure that the entity adheres to the regulations. For instance, the 18% cash ratio mentioned earlier forces banks and NBFI’s to look for other income generating avenues to make up for the income lost had they a choice of investing the monies held at the CBK.
4. Reduction of innovativeness:

Regulations play a very big hand in inhibiting the innovative potential of market participants. However, regulations are also referred to as the ‘mother’ of innovation. This reference points to the fact that due to the ‘barriers’ put in place through regulation, participants in the market either invent ways and means of ‘going around’ any such ‘barriers’ or of getting into other markets.

2.2 Economic Reform Measures:

Having decided to use structural adjustment as the means of steering the country forward, the Government went ahead to recommend and implement economic reform measures which include the following:

- Restructuring of weak financial institutions and strict application of prudential regulations by the Central Bank which resulted in the liquidation of some institutions.

- Amendment of Banking Act to strengthen the capacity of CBK to supervise and regulate the monetary system. This move was also aimed at contributing to the control of money supply.

- Deregulation of interest rates. This involved raising nominal interest rates to reduce the gap with real interest rates. In essence, this meant that the supply of loanable funds increased resulting from increased incentives to savers leading to decreases in the rationing of credit to borrowers.

- Exchange rate management. The measures taken in this regard included the removal of virtually all foreign exchange control laws – this resulted to some banks having foreign exchange bureaus within their banking halls; export development and promotion; introduction of retention accounts to give incentives to exporters. According to Professor Ryan of the Ministry of Finance, “The liberalisation of the exchange rate was necessary to integrate and balance the Kenyan economy with the world economy.” (The Chief Executive Forum Report, August 1993, p. 23).

- Price liberalisation – In this regard, the measures taken are aimed at increasing producer prices and removal of price controls. Along with these was the removal of administrative controls aimed at enabling goods and services to
move from surplus to deficit areas. The liberalisation of import licensing was also a move toward reforming prices.

- Complete liberalisation of marketing and pricing of maize and petroleum products. The purpose of this measure was to curb poverty by ensuring better distribution of food products more evenly to those in living in poverty.

- Reforming the civil service. This move though harsh was aimed at retrenching civil personnel and privatisation of some of the non-strategic parastatals. In this respect, the Government is conscious of the adverse social effects of the adjustment programme. In order to cushion the most vulnerable segments of our society from these costs, the Government has taken a number of steps such as making allocations for severance payments for retrenched workers, and formulating a social dimensions programme which focuses on improving the provision of basic social services e.g., primary education and health care. (Monthly Economic Review, January 1995, p 2-3)

The impact of the changes prescribed by the liberalisation brought to an abrupt halt the static environmental conditions within which businesses in Kenya operated. The Government has the encumbrance of providing a conducive environment fertile enough to foster economic growth. This, according to Professor Ryan, involves giving monetary and fiscal policy incentives to promote private sector investments and employment. He further states that, “Effectiveness and efficiency in operations as well as market orientation will be the rule of the game in the private sector.” (The Chief Executive Forum Report, August 1993, p. 16)

Within the new environmental operating conditions, the Government also realised that it had to change its operational tactics. As a result, through the Central Bank policies, the Government tended to lean more towards moral suasion than the former interventional tactics. To a very large extent the Government took more of a facilitatory and regulatory role as opposed to the previous participatory role.

As far as the financial sector is concerned, Professor Ryan enumerates several aspects that impact on this sector:
Private sector establishment of specialised financial institutions to cater for the diverse needs of the Kenyan saver and borrower;

- More participation by Kenyan's in the stock market as a result of the development of the capital market;
- More access to credit as the Government reduces the size of its local borrowing;
- More use of equity rather than debt investment financing, as the capital and money markets become more efficient and as the activities of the Nairobi Stock Exchange (NSE) become more informative and transparent. (The Chief Executive Forum Report, August 1993, p. 16-17)

The environmental situation within the financial sector is well described in the editorial comment of the January, 1995 issue of the Kencom Digest which states that "...the monetary authorities have had to grapple with the dynamics of a deregulated financial sector." as they struggle to steady the financial boat as a result of the unsettling environmental conditions.

2.3. The Impact of Financial Liberalisation on the Financial System.

According to Jaramillo et.al. (1993), "It has been forcefully argued that heavily regulated financial systems - which are characterised by very low interest rates, government interference in the distribution of credit and preferential treatment for priority sectors - have serious drawbacks." (p.1). The Kenyan financial system was no different from this description before liberalisation. For instance the ceiling on interest rates discouraged savings. Prior to the deregulation, all sectors in Kenya were heavily regulated - the banking sector being no exception. These regulations particularly as pertains to the Banking Act were responsible for triggering a big migration to the banking sector from the Non Banking Financial Institutions (NBFIs) sector. The government, through CBK employed stringent and demanding requirements which had a migratory effect into the banking industry in as far as the financial sector was concerned. The following are some examples of expectations that banks and NBFIs are required to fulfil by CBK:

- The main players in the financial industry, namely banks and NBFIs were mandated to retain 18% cash ratio of their total deposit holdings. These
vast amounts of money are actually non-interest earning and as such, prove
to be very expensive to maintain therefore increasing the cost of money.
For most NBFI s whose main businesses are fixed deposits and loans as
opposed to commercial banks which have more income generating
businesses, this requirement was too expensive and, in many cases,
unaffordable. Mutahi Mureithi emphasised this point in the Business Week
when he says, “...smaller institutions claim legitimacy over the assertion that
the cash ratio was hurting them since the larger banks source their deposits
interest-free.” (The Daily Nation Tuesday, October 14, 1997). For
example, as of September 15 1997, banks and other financial institutions that
are obliged to conform to the cash ratio requirement had a total of KShs.
43.5 billion at the Central Bank in the form of cash ratio.

This unfortunate turn of events initiated a lot of restructuring and complete
overhauling of business strategies. The restructuring in the NBFI sector
obviously had an overbearing effect on the banking institution structure.
The main strategies employed by NBFI s to counteract the ravaging effects
of these regulatory expectations were mainly mergers, conversions and
acquisitions by existing banks.
In essence, these three moves, i.e., mergers, acquisitions and conversions,
saw a definite and most significant increase in the number of banks in Kenya.
The pre-existing requirement of retaining 25% liquidity of assets (which has
since been reduced to 20 % with effect from August 1997), along with the
18% cash ratio (currently at 12%) was certainly another limitation that faced
NBFI s.
### Table 2.1

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<tr>
<th>NAME OF FINANCIAL INSTITUTION</th>
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<td>Akiba Loans and Finance Ltd</td>
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<td>Co-operative Merchant Bank</td>
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<td>First National Finance Ltd.</td>
<td>First National Finance Bank Ltd.</td>
</tr>
<tr>
<td>Habib Kenya Finance</td>
<td>Habib African Bank Ltd.</td>
</tr>
<tr>
<td>Imperial Finance Co. Ltd.</td>
<td>Imperial Bank Ltd.</td>
</tr>
<tr>
<td>Investment &amp; Mortgages Ltd.</td>
<td>Investment &amp; Mortgages Bank Ltd.</td>
</tr>
<tr>
<td>Lake Credit Finance Ltd.</td>
<td>Reliance Bank Ltd.</td>
</tr>
<tr>
<td>Prudential Finance</td>
<td>Prudential Bank Ltd.</td>
</tr>
<tr>
<td>Southern Credit Finance Ltd.</td>
<td>Southern Credit Banking Corp. Ltd.</td>
</tr>
<tr>
<td>Universal Finance Ltd.</td>
<td>Universal Bank Ltd.</td>
</tr>
<tr>
<td>Victoria Finance Company Ltd.</td>
<td>Victoria Commercial Bank Ltd.</td>
</tr>
<tr>
<td>National Industrial Credit Ltd.</td>
<td>National Industrial Credit Bank Ltd.</td>
</tr>
<tr>
<td>Diamond Trust Company</td>
<td>Diamond Trust Bank Kenya Ltd.</td>
</tr>
</tbody>
</table>

FINANCIAL INSTITUTIONS THAT MERGED WITH EXISTING COMMERCIAL BANKS AS AT 31.12.96

Table 2.2.

<table>
<thead>
<tr>
<th>NAME OF FINANCIAL INSTITUTION</th>
<th>NAME OF MERGING BANK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indosuez Merchant Finance</td>
<td>Banque Indosuez</td>
</tr>
<tr>
<td>First American Finance</td>
<td>First American Bank</td>
</tr>
<tr>
<td>Transnational Finance</td>
<td>Transnational Bank Ltd.</td>
</tr>
<tr>
<td>Stanbic Finance Kenya Ltd.</td>
<td>Stanbic Bank Ltd.</td>
</tr>
<tr>
<td>Mercantile Finance</td>
<td>AmBank Ltd.</td>
</tr>
<tr>
<td>C.B.A. Financial Services</td>
<td>Commercial Bank of Africa</td>
</tr>
<tr>
<td>Delphis Finance Ltd.</td>
<td>Delphis Bank Ltd.</td>
</tr>
<tr>
<td>Ken Baroda Finance</td>
<td>Bank of Baroda</td>
</tr>
<tr>
<td>Trust Finance Ltd.</td>
<td>Trust Bank Ltd.</td>
</tr>
</tbody>
</table>


2.4. **Response by Banks:**

As the number of institutions that subscribed to the NBFI sector diminished and the economy witnessed an increase of participants in the banking sector, the question that loomed unanswered is whether Kenya is ‘over banked’ for a country with its size of economy. Given the number of banks vis-à-vis the size of our economy, there is no doubt that banks have had to sharpen their tools in order to survive amidst the increased competition. Other than the threats posed by the increased number of banks, there were opportunities that were created by the liberalisation. To improve their survival, banks employed various strategies which included product innovation, investment technology, organisation restructuring amongst others.
Graph 2.1.

MIGRATION TO THE BANKING SECTOR FROM THE NBFI SECTOR

Needless to say, numerous NBFIIs and some banks went into liquidation and receivership as a result of failure to maintain the regulatory demands required of them.

Graph 2.2.

BANK FAILURES FROM 1987 TO 1996

The impact on the banking industry depicted by the graphs above shows the tremendous effect that financial liberalisation had on the banking industry especially the conversion of
NBFIs to commercial banks and the collapse of banks due to more stringent supervision by the Central Bank.

2.5. **The Role of Information Technology:**

At this juncture, we can ill afford to ignore the occurrence of yet another vital phenomenon that took place at about the same period as the revolution in financial retailing not just in Kenya but globally: that of the great information technology revolution better known and abbreviated as I.T. The impact that the I.T. revolution had on the overall world economy and especially the financial world is immense. In Kenya the situation was not different as the financial sector, with emphasis on the banking sector, responded to the changes demanded by the new I.T. know-how. As time went by, it became more apparent that banks in Kenya virtually had no choice but to invest and for others to re-invest in I.T. As such, it was time for entrenchment. The Kencom Digest points out that some of the big banks invested heavily in computer and modernisation programmes (Vol. 13 No. 1 p.1). For certain banks such as Kenya Commercial Bank (KCB) which pioneered the introduction of computers in banking in Kenya as early as 1968, the entrenchment signified a thorough and major re-investment in I.T.

Prior to the financial liberalisation and the I.T. revolution, major banks in Kenya the likes of Barclays attributed a whopping 80% of operating costs to staff costs. However, with the implementation of the new computer technology, these costs were reduced significantly to 60% as in the case of Standard Chartered. Significant though the 20% difference may seem, this figure is still high when compared to 40-42% of operating costs channelled towards staff costs in industrialised countries. As it is correctly pointed out in the *Sunday Nation*, March 30 1997, p.7, the difference of 18% is indicative of inefficiencies in the banking sector. These inefficiencies, according to financial analysts, can be curbed by more investments in computerisation and thus computer related innovations which would, in effect, not only increase efficiency but also decrease the number of clerical and junior management staff required.

It is, therefore, important to note the relationship between these two revolutions in that, the revolution in finance retailing would have been impossible without information
technology (IT). Undoubtedly, the role played by IT in the revolutionisation of banking services cannot in any way be down played.

2.6. **Bank Innovations:**
As Kenya experienced various impacts of financial liberalisation, the banking industry was the target of far-reaching reforms mainly because of its critical role in the smooth functioning of the economy. After many years of operations under the umbrella of controls and Government supervision, it was time for the banks to be innovative. The effort that banks put into these creations resulted to a revolution in financial retailing.

In their research of the role technology has played in financial products and services, McGoldrick and Greenland point out that, “Financial products and services differ from most other retail goods in two respects. First, they generally take the form of a contract with obligations which can endure for years. These contracts generate ongoing servicing costs for the supplier, as well as future income. Second, financial products are ‘manufactured’ within computer systems.” (McGoldrick and Greenland, 1994, p.35)

The speed with which product innovation is developed means that rivals can easily copy it and this therefore endangers the possibility of a sustainable competitive advantage, especially in the developed countries.

In the field of financial innovations, not unlike many others, IT does provide a competitive edge. This advantage is achieved by using IT to realise economies of scale, for instance via the automation of routine tasks or by increasing the speed with which management information is communicated around an organisation. Once again McGoldrick and Greenland point out the advantages of IT citing that, “IT can offer an edge where computer software, hardware, market research and business development combine to generate new forms of financial services such as telephone banking and data base marketing.” (McGoldrick and Greenland, 1994, p.35)

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1 The term ‘manufacture’ in this case refers to the fact that one can come up with a new product within a very short time span by changing a few parameters in a computer program.
It is a foregone conclusion that information technology possesses an integral role in the response made by banks and NBFIs to the new financial arena. Other than the ‘manufacturing’ capability unique to IT, the efficiency and accuracy that is characteristic of this technology provides certain product differentiation to all products. To this end, it is important to note that just about all the bank innovations and repackaged products use computers or computer knowledge as their foundation, implementation and execution.

As pointed out by Peter Goldrick, it is important to note that in the financial industry and other IT based industries, innovations “…do not necessarily require new products, and may be classified into 3 main categories:

- Continuous innovations – These have the least disruptive influence upon consumers’ established behaviour patterns, e.g., automatic ordering of new cheque books.

- Dynamically continuous innovations – These have some disrupting influence upon patterns, e.g., the use of debit cards instead of credit cards at the checkout.

- Discontinuous innovations – These do require new patterns of behaviour, e.g., the use of ATMs or home banking.” (McGoldrick and Greenland, 1994, p. 200.)

Innovations as described above relate to the level of newness as perceived by the customer. This is an essential perspective to take into consideration when trying to predict customer reactions and rates of diffusion.

The triggering forces of innovations can be narrowed down to three. In most cases, as McGoldrick points out, there is “…an evolutionary process, driven by competitive forces, technological change and … retailers’ perceptions of customers needs.” (McGoldrick and Greenland, 1994, p. 200) On the whole, ideas can be classified as being of internal or external origin. Internal sources of ideas include specialist research and development, individual executives or other company employees. On the other hand, external sources of ideas are more diverse because they include research and technological developments
within various outside agencies. Agencies in this case, refer to other companies who can be competitors, distributors or associated companies.

In Kenya and specifically in the financial sector, a major impetus for development is government legislation. This statement holds true for financial sectors in Europe and other parts of the world as well. The Kenyan government set off the mills of innovation grinding by deregulating the financial sector. Deregulation opened up the market place to other players from the world over. In essence, competition increased, the rules of the game changed and customer awareness rose. The Kencom Digest echoes this sentiment in one of its article on new products in the banking industry by stating that, “Although the new services and products introduced may be aimed at improving service and giving customers a wider choice, it is also a direct response to competition for corporate clients in a market that is becoming increasingly sophisticated.” (Kencom Digest, October, 1995, p. 3)

Indeed, there is quite a large scope for development of innovations and more specifically for financial players to assert their competitive position. In truth, bank innovations were developed to counteract the effects of the financial liberalisation.

In summary, most of the studies reviewed and forums held on financial liberalisation go to show that the deregulation of our economy prompted financial participants to be more imaginative and innovative if they are to survive in what is now a highly competitive global village.
CHAPTER THREE

RESEARCH METHODOLOGY

3.1. **Introduction:**
This chapter presents the details of the research design employed in this study in a bid to achieve its projected objectives.

3.2. **Population and Period:**
This study is mainly concentrated on the period 1989 to 1997, the population of which constitutes all banks registered in Kenya during this period. The year 1989 was chosen because most of the information and data pertaining to the implementation of financial liberalisation was readily available from this year as well as references to actions and reactions during the previous years to the liberalisation. 1997 was selected mainly because the banking industry had started stabilizing somewhat amidst all the changes within the operating environment.

3.3 **Sample:**
The following rules of sampling were applied in this study in order to arrive at a more comprehensive and comparative analysis:
1. A bank must have been licensed to operate as a commercial bank in Kenya prior to the period under study (1989 and 1997).
2. Availability of annual financial statements for the study period.
3. A bank should have a branch network of not less than 20 fully fledged operating branches countrywide.

Upon application of the above criteria on all 54 banks operating in Kenya as of 1997, only 4 banks qualified. These are: Barclays Bank of Kenya, Standard Chartered Bank, Kenya Commercial Bank and National Bank of Kenya. The sample criteria applied could have introduced a stringent survivorship bias especially the fact that banks were required to have at least 20 fully-fledged branches countrywide. This last criteria specifically served the function of analyzing the products offered in the urban areas compared to those
offered in the rural areas by the banks which have command of over 50% total banking market share countrywide.

3.4. **Data Collection:**
This study relied heavily on secondary sources of data. The data applied is derived from a series of Central Bank surveys and analysis as well as on information garnered from government policy papers e.g. the Policy Framework Paper, bank annual financial reports, the Monthly Economic Review, CBK statistical bulletins, finance journals, newspapers, and various books on finance especially pertaining to financial liberalisation and retailing. The above sources of data were obtained from the Central Bank, the sample banks, the World Bank and various other libraries.

3.5 **Data Analysis:**
Data used in this study was analyzed graphically and by means of tabulation. The analysis is classified as follows:

1) Government policies as concerns financial liberalisation, the liberalisation’s effects on banks as well as expected and actual reactions from banks.

2) The presence or lack thereof of particular products within the sample banks product range.

3) Product market share command.

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This is analyzed on tables 4.1. Banks Reaction to Government Policies and 4.2. Product Presence.
CHAPTER FOUR

RESULTS AND FINDINGS

4.1 **Introduction:**
This section presents the results and findings of the study. The objective of this study was to prove that the genesis of bank product innovations in Kenya was a result of banks response to the financial liberalisation. The results of this study pertain to a sample of banks in Kenya all of which represent subsidiaries of MNCs as well as indigenous banks which have international bank affiliations. Suffice to say that these results may vary from country to country since different countries have had varying post liberalisation financial and economic structures.

4.2 **Coverage:**
The four sample banks used in this study are shown in Appendix A. This sample was extracted from a possible sample of fifty-four banks thus representing about 7.4% coverage in number of the Kenyan banking fraternity.

The researcher considers 7.4% coverage in number to be sufficient bearing in mind the difficulty of acquiring data in this sensitive industry as well as the study period taken. However, since these banks have a heavy presence in the industry country wide and represent a combined possession of 93%³ of the local product innovations market share, they are sufficient to enable meaningful and valid conclusions to be arrived at concerning the introduction of bank innovations in Kenya.

4.3 **Analysis of Findings:**
The following is an analysis of various findings arrived at during the study.
4.3.1. Banks Reactions to Government Policies:

The table below indicates the Kenyan Government’s policies as pertains to financial liberalisation and the subsequent reaction(s) by each of the sample banks.

<table>
<thead>
<tr>
<th>LIBERALISATION ACTION</th>
<th>EFFECTS ON BANKS</th>
<th>EXPECTED REACTION(S)</th>
<th>ACTUAL REACTIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Ratio requirement.</td>
<td>&gt;Cost of money increased &gt;Banks had less cash at their disposal.</td>
<td>&gt;Increase in base lending rate. &gt;Introduction of high interest earning accounts.</td>
<td>&gt;Nothing &gt;Slight increase in base lending rate.</td>
</tr>
<tr>
<td>(1994)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Base capital Raised to Kes 200 million.</td>
<td>Banks had to reserve more money aimed at increasing their base capital.</td>
<td>&gt;Banks put in more concerted efforts towards increasing revenue.</td>
<td>&gt;Refurbished the saving accounts.</td>
</tr>
<tr>
<td>(June, 1996)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deregulation of interest rates.</td>
<td>Supply of loanable funds increased due to incentives offered to savers.</td>
<td>Most banks had less ‘red tape’ in the qualification of granting of loans. They introduced attractive products aimed at loaning money to different</td>
<td>&gt;Had one of the lowest base lending rates but still bureaucratic in granting of loans.</td>
</tr>
<tr>
<td>(October. 1993)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reform of foreign exchange system. (October, 1993)</td>
<td>Banks had an added opportunity for revenue generation.</td>
<td>Most banks opened up in-house foreign exchange bureaus.</td>
<td>Opened a foreign exchange bureau.</td>
</tr>
<tr>
<td>Amendment of the Banking Act.</td>
<td>Introduced more stringent supervision by CBK.</td>
<td>Banks had to adhere more strictly to CBK requirements when filing returns for supervision purposes.</td>
<td>Complied with Central Bank’s requirements.</td>
</tr>
<tr>
<td>Conversion of NBFIs into commercial banks. (1994)</td>
<td>Competition increased.</td>
<td>Banks became more innovative and changed their strategies to increase their customer base.</td>
<td>Continued on its focused as the ‘people’s bank’ by trying to serve all segments of the market with special emphasis on the parastatals.</td>
</tr>
</tbody>
</table>

4.3.1.a) **Analysis and Interpretation:**

From the above observations, it is apparent that while some of the liberalisation actions presented a competitive atmosphere, others presented the banks with new revenue avenues. For instance, the conversion of most NBFIs into commercial banks increased the number of banks significantly. However, the market share size did not necessarily increase because most of the banks were concentrated on the urban market niche. This action resulted in many responses from pre-existing (mainly the sample banks) and new banks. Amongst the major responses intended at retaining their competitive positions was product innovation. On the other hand, reforms of the foreign exchange system offered the banking industry new business opportunities such as the introduction of various foreign exchange-based products and exchange bureaus.

As expected, the analyses show that each of the reform measures implemented provoked a reaction from the banks. These reactions, which in this case were in form of product creation or remodelling, were aimed at counteracting the effects of the reforms either by minimising the threats or maximising on the opportunities presented by financial liberalisation.

In as much as the sample banks seemed to have had basic similar reactions these differed in implementation time frame, success, and magnitude largely due to unique attributes of each of the them such as target market, financial muscle, strategy and technical resource endowments amongst others.
4.3.2. **Product Presence:**

The following is a tabulated analysis of the banks' reactions to the various effects of the liberalisation by way of innovations, their implementation time and some reasons for product presence. In this analysis, several products offered to a cross-section of urban Kenyans have been coded and their presence entered against the sample banks.

<table>
<thead>
<tr>
<th>PRODUCTS</th>
<th>BBK</th>
<th>KCB</th>
<th>SCB</th>
<th>NBK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Efforts to curve a competitive edge in the 'plastic' market.</td>
<td>Attempts to retain upper-middle class customers.</td>
<td></td>
<td>Response to competitive effects of financial liberalisation</td>
<td></td>
</tr>
<tr>
<td>DC</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>✓ (1997)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Aimed at increasing 'plastic' market share.</td>
</tr>
<tr>
<td>Application of existing international IT knowledge and Response to SCB introduction of ATMs.</td>
<td></td>
<td>Application of IT knowledge and response to customer awareness.</td>
<td>Response to competitive introduction of ATMs.</td>
<td></td>
</tr>
<tr>
<td>IC</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Response to competitive effects of the economic reforms.</td>
<td></td>
<td>Response to competitive effects of the economic reforms.</td>
<td>Response to competitive effects of the economic reforms.</td>
<td></td>
</tr>
</tbody>
</table>

*Plastic refers to the use of card and magnetic strip technology used in lieu of cash or cheques.*
Where:

CC  > Credit card.
DC  > Debit card.
ATM > Automated Teller Machine card.
IC  > Interest earning current accounts.
HS  > High yielding savings accounts.
FX' > Foreign Exchange based products

✓ - Symbolises the presence of a particular product being offered by a bank.
✓ * - Indicates for NBK that in as much as the bank has ATM and Credit cards it does not have enough Automated Teller Machines. National Bank has entered into agreements with Barclays, which has numerous cash dispensing machines, to facilitate the use of these machines by NBK cash withdrawal cardholders.
X  -indicates that a particular product is not offered by a bank.
Where:

CC  > Credit card.
DC  > Debit card.
ATM > Automated Teller Machine card.
IC  > Interest earning current accounts.
HS  > High yielding savings accounts.
FX  > Foreign Exchange based products
✓   - Symbolises the presence of a particular product being offered by a bank.
✓ * - Indicates for NBK that in as much as the bank has ATM and Credit cards it does not have enough Automated Teller Machines. National Bank has entered into agreements with Barclays, which has numerous cash dispensing machines, to facilitate the use of these machines by NBK cash withdrawal cardholders.
X   -indicates that a particular product is not offered by a bank.

4.3.2.a) Analysis and Interpretation:

The tabulated analysis shows that some of the banks selected have most if not all of the common bank innovations. The most common feature with these banks is their heavy capital base\(^5\). For example, BBK and Standard Chartered are subsidiaries of multinational corporations (MNCs) while banks like KCB and NBK are indigenous banks albeit the fact that they both have heavy government investments. By and large, the fact that bank innovations are an appropriate leverage tool to use as a measure of gaining competitive advantage during the extremely competitive times following financial liberalisation, comes out as an expensive affair. Suffice to say that apart from the heavy investment required, experience in the introduction and eventual implementation was evidently important. BBK and SCB transferred technology already in use in their branches in developed countries while KCB and NBK benefited from their international correspondence affiliation.

The muscle described above explains why the four banks command 93% of the local product market share. The resources that these banks have are not only restricted to finance but include other resources such as information technology, human resources with technical know-how as to
the applicability of the information technology and experience. Indeed, information technology formed the basis upon which products were created and operated.

Across the banking industry the presence of most bank innovations is restricted to either of the two categories of banks mentioned earlier i.e., MNCs or indigenous banks with heavy government support. It is also important to note that these are amongst the banks that were in existence prior to economic reforms and therefore had to protect their interests in the face of increased competition for the same market share. Kimura (1998) strongly points out that, “It is also apparent that we cannot talk blithely of a ‘level playing field’ when the players in that field have distinctly different capabilities or endowments. A branch of a multi-national bank has vastly more capacity than a small local institution and the notion that they can compete equally is fallacious.” This observation is clearly illustrated in Graph 4.1.

This study also highlighted that the most common and notable of bank innovations are mainly in the consumer credit market. These are mainly non-cash instruments such as credit cards, debit cards, ATM cards, personal cheques, bankers cheques and bank transfers, for example, electronic funds transfers (EFTs) amongst others.

4.3.3. Product Market Share Command:
The pie chart below indicates market share possession for all locally applicable innovations combined per bank.

\[\text{The CBK directory of commercial banks ranks the four sample banks under peer group 1 which is indicative of} \]
As described in the interpretation above, it is no wonder that the 4 sample banks command a combined 93% chunk of the market share in terms of local product innovations.
CHAPTER FIVE

CONCLUSION, RECOMMENDATIONS AND LIMITATIONS

5.1. Conclusion:

The epitome of this study is that the innovation arena has been extensively utilised in the recent years to retain and increase market share in the face of financial liberalisation effects. However, it is apparent that there is scope for more development especially in the rural market niche which is still dominated by the traditional mediocre banking services, products and solutions. The common practice of applying in Kenya products that have been in existence in the developed countries is to blame for this partiality of the spread of innovations. Another reason for this partial spread of bank innovations is that competition for the rural market has not really heightened. This market is largely shared amongst 5 commercial banks.

Consequently, my view garnered from this research is that despite the heavy investment in innovations, banks have only served all but one sector in the country – the so called “urban elite” group. The fact that most of the banks on the fore front of innovations, as represented by the sample banks, are the ones with the largest branch network countrywide, goes to show that the infrastructure to better serve the rest of the country with suitable and applicable innovations, has been laid down. If these banks could implement the new products in the rural areas the Kenyan rural population will benefit from this rippling effect of financial liberalisation and thus be incorporated into the wider global village.

5.2. Recommendations:

The banking industry in Kenya should assess the needs of the local market at large and come up with creations that serve the entire local banking market and at the same time have the capability of being inter-linked with those offered internationally by utilizing the available technical resources. For this to be achieved, the monetary authorities should restructure the banking industry. Essentially, this means that the authorities should work in favour of supporting national efforts through a variety of incentives and other forms of assistance such as management, training, networking etc.
To concur with Peter Drucker, "Innovation begins with a conscious search for opportunities" (*Harvard Business Review* p.149, November-December 1998). In as much as the financial liberalisation presented threats and highlighted weaknesses within the banking sector, it none the less brought with it new opportunities. Banks in Kenya have the onus of seizing these opportunities by utilizing their individual and collective strengths, focusing their efforts and coming up with creative ways of capitalising on this new scope nation wide.

5.3. **Limitations:**

The major limitation of this study was lack of easy access to necessary information mainly from the primary source. As a result of liberalisation which is a new phenomenon in the country, the banking industry is yet to get used to open competition and discussion. This limitation was however compensated by Central Bank’s efforts of achieving transparency within the banking sector. The endeavour by CBK to have banks disclose more relevant information in the recent past served as a great source of important information which would otherwise not have been forthcoming.

5.4. **Suggestions for Further Research:**

The following research aspects would be vital if the findings and conclusions arrived at in this study were to be validated and thus generalised especially for Third World economies that are yet to be liberalised or currently implementing liberalisation reforms.

The first proposal is for a similar study to be carried out in other countries that have or had similar pre liberalisation economic structures. Application of a different sample selection criteria as well as other aspects unique to such countries can be utilized to study the banking sectors response to financial liberalisation.

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5 The primary source in this case refers to persons that were interviewed during the course of this study with specific reference to the selected banks.

7 CBK as a public watchdog has a substantial responsibility in requiring banks and NBFI’s to not only publish much more information about themselves than they will freely do and to do so without being pressurized into doing so. Banks are atrociously shy when it comes to disclosure... (*Kimura*, p. 15 Financial Structures for Sustainable Growth.)
Secondly, this study can be replicated for the rest of the banks in Kenya. In this case the basis of the sample would have to change in keeping with the banks attributes. In so doing, such a study would reveal and highlight other forms of responses to the liberalisation other than product innovation.
APPENDIX A

SAMPLE BANKS

1. Barclays Bank of Kenya
2. Standard Chartered Bank
3. Kenya Commercial Bank
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