**The Effect of Product and Service Innovations on the Financial Performance of Commercial Banks in Kenya**

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**Abstract**

The objective of this study was to establish the effect of product /service innovations on the financial performance of commercial banks in Kenya. The 40 commercial banks being population of this study which were in operation in Kenya as at December, 2017. Primary and secondary data were collected and explanatory research design used. Quantitative analysis in the research was facilitated by Statistical Package for Social Sciences. Analyzed results from completed questionnaires presented in tables. The results showed that most commercial banks have concentrated on their profits by creating new products/services which have minimized their operational costs. The study recommended that banks should consider incorporating the new technology as it will increase the firms’ performance by facilitating reduction in cost thus improved return on assets. Financial institutions should ensure that banking innovations are secured for customers to have confidence in mobile/internet banking.

Key terms: financial performance, product/service innovations, commercial bank

**Introduction**

The industry of banking sector is a major driver to economic development for world economies. By offering different types of services, such as facilitating money transfers between countries and ensuring that savers and borrowers are brought together in well-organized structures, the industry determines countries’ economic development and long-term sustainability (Muriithi, & Louw, 2017). Banking sector is one industry that happens to be in competition with the quick changing markets with rapid advancing technology and is required to give positive results so innovations must be done, failure to which, it risks being overtaken by competitors.

In finance, information technology is both exciting and valuable in terms of the operational and strategic benefits it offers. Information Technology gives financial institutions advantages in terms of reduced operating costs, improved customer service and diverse product offerings as it enables better assets – risk management and innovative market research. In the Indian banking context, almost all banks have incorporated Information Technology (IT), in their strategies and operations but at different levels depending upon the driving forces and obstacles for its successful implementation. In the Kenya’s money markets, the profit- oriented companies are regularly pursuing new and enhanced products/services and organizational forms that can cut their expenses on production, better the customers’ needs in order to make huge profits.

Bank clients dictate for diversity, improved and quality services. Consumers need services that can accommodate the specific, individual requirements. Advanced technology in the past years has enabled banks to work on the challenging areas. According to Malak (2014), In Kenya, commercial banks have been steady in the innovation of new services, products and governance for it to upgrade financial performance. The financial sector has over time developed successfully with innovation products/ services available in financial market. However, the impact of bank innovation on performance still has a gap in the research field despite the positive results; it has undeniably caused damages such as fraud.

**The Problem**

The problem was, innovations to banks are costly and the extent to which product and service innovations have impacted the banks is less. Kenya’s innovation implementation level is more competitive in the financial banking sector. The impact of product and service innovation on performance still has a gap in the research field despite the positive results; it has undeniably caused damages; fraud and is a great deal of time-wasting activity hence the inadequate understanding about the product and service innovations. Moreover, some banks have encountered loses due to failure in the innovation processes hence this necessitates the need to determine the effects of product/service innovations on financial performance of commercial banks in Kenya

**Objectives**

The objective of this study was to analyze the effect of product/service innovations on the financial performance of commercial banks in Kenya.

**Literature Review**

According to Kotler (2011), a product is anything that can be provided to the interest, purchase, use or use of a customer that may fulfill a need or a wish. Therefore a commodity can be a tangible good, a service or a concept. Innovation in the product is the development and subsequent implementation of a good which is new or an improvement on initial goods and services (Azaze, & Haji, 2005). Product developments have an emphasis on the consumer and are driven primarily by consumers. Consumer innovation includes that banks assimilate customer needs, alter the demographics and provide new ways of entering banking markets. Product and service innovation is the product of recreating the modern way of solving the dilemma of consumers, which will ultimately benefit both customers and banks.

Both external and internal factors contribute to the development of innovative products tailored to particular needs and unique niches. Market research, the exchange of new product/ service ideas between banks and study, or technological developments, is significant external factors. Internal factors could include in-house creation of new products, testing and review of existing products. Gupta, (2013), concluded that community banks would implement new banking products and services that are more attractive to evolving consumer base in order to remain competitive in the market place and that online banking can be among the choices for electronic banking system. Gabriel and Valentin, (2007), in their analysis they concluded that there is a significant contribution to the income of small and large banks from an ideal product mix. They added that the difference in performance between the biggest banks and the smallest banks stemmed from the hedging impact of technological change. The impact of product innovation on the financial performance of mobile phone companies in Kenya was analyzed.

Electronic banking has witnessed tremendous growth and has revolutionized traditional practices in banking (González, Cunill, & Lindahl, 2016)). Malhotra and Singh (2007) conclude that, e-banking is leading to a fund amental change in marketing practices resulting in improved performance in the banking industry. Financial innovations enable various companies to raise money in larger amounts and at a cheaper cost than they could elsewhere (Lerner, 2006). It becomes evident that there is a tendency for a bank to reduce costs and expenditures. The other major benefit from e-banking innovation is fee based income (Dew, 2007). If a bank joins in an ATM network, it can generate income from other banks’ customers that use its ATM machines or from third parties that cooperate with it. If a bank conducts more transactions with a third party, the more fee based income it acquires. This in turn forces the bank to enrich features of e-banking transactions, such as mobile telephone top-ups, ticketing, paying telephone or electricity bills, house taxes. Joining a certain ATM network will also create customer awareness of that bank and influence the market share (Hasan, Schmiedel & Song, 2009).

In the summer of 2012, the UK's Royal Bank of Scotland (RBS) and America's Knight Capital both suffered profoundly significant process failures. RBS Bank lost the ability to process payments in June 2012, leading to an update to the CA-7 batch scheduling process for banks. Some of the bank's clients were left stranded overseas, fined for late bill payments and a Mexican hospital customer was targeted. Some of the bank's clients were left stranded overseas, fined for late bill payments and a customer in a Mexican hospital was threatened with the loss of his life-support machine, all due to inaccessibility to their finances (Pex network staff, 2014).

**Methodology**

Explanatory research was adapted since the target of the study was to understand the attribute and forms of the link and association between the independents and dependent variables. This kind of research is suitable for this sort of study because it sought to explain the link between two variables during which one variable led to a specified effect on the opposite variable as argued by Cooper, Schindler & Sun, (2006). Explanatory research sought to acknowledge and explain a relevant link association which was considerably relevant and worthwhile. The link that was examined during this study was the consequences of product/service innovation on financial performance of commercial banks in Kenya.

The study was carried out in Nairobi, Kenya. This area was chosen because all commercial banks operating in Kenya have their head offices in Nairobi in which finance, IT, operational and risk department managers who have more detailed information, are located easily which was the main focus for this study. This study population comprised of the 40 Kenya’s commercial banks as at 31st December, 2017 that had been operating between 2010 and 2017.The period was calculated sufficient time to provide adequate variables to assist in verifying the effect of product/ service innovations on financial performance. This period was chosen so as to apprehend the foremost recent data and to grant results that were irrefutable and reflected the recent trend.

The sample of banks was chosen due to ease of access to information. Proportionate Stratified random sampling was used to get samples from the various categories of respondents, as these categories were expected to possess almost similar characteristics. The sample size was determined by the following formula recommended by Nassiuma (2000), for determining sample size.  ……………………………….equation (3.1) Where: ***n***= sample size, N = Study population size; C = coefficient of variation; 20%≤C≤30% 50%, *e* = error margin; 0.02≤e≤0.05.

Calculating the sample size,

n = 40(0.3)2

0.032 + (40-1) (0.05)2

= 19.2

***n*** ≈ **20**

For each sample of commercial banks, three staff members (General finance manager, risk manager and IT manager) were given each a questionnaire making the total number of respondents in the study to be 60 when the entire population was sampled.

**Results and Findings**

*Table 1.Your Bank Is Involved In Product /Service Innovations Response Frequency Percentage (%)*

|  |  |  |
| --- | --- | --- |
| **Response** | **Frequency** | **Percentage (%)** |
| **Yes** | 48 | 100% |
| **No** | 0 | 0% |
| **Total** | **48** | **100%** |

According to the response from randomly selected banks, they all were in agreement that they have ventured into product/service innovations. Out of the 48 respondents, 100 per cent acknowledged that they have been practicing the product/service innovations.

*Table 2. Periods of Bank’s Involvement in Product / Service Innovation*

|  |  |  |
| --- | --- | --- |
| **Response** | **Frequency** | **Percentage (%)** |
| **Not within 2010-2017** | 0 | 0 |
| **Within 2010-2017** | 48 | 100% |
| **Total** | **48** | **100%** |

Respondents were asked about the duration the banks had been venturing into product/service innovations and results shown in Table 2. It was concluded by the study that, all the Kenyan commercial banks have been venturing into product/service innovations and have been providing new and significantly improved products/ services to their customers for the period 2010-2017 as indicated by the 100 per cent response rate. Investing in product/service innovation is one of the key activities in the new millennium in order to facilitate increased profitability. The introduction of Equitel by Equity Bank and Agency banking services by Cooperative Bank can be attributed to positive shift of the past products to new improved products. Application of new technological products and services has facilitated banking industry in Kenya to expand from 4.6 per cent in 2011 compare to 2.7 per cent in 2010 (CBK 2007).

*Table 3. Product /Service Innovations and Financial Performance*

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Questions | SA | A | M | D | SD |  | **P** | ROA  (%) |
| Customers are able to receive money on their mobile phones | 39(81.25) | 9(19%) | 0(0.00%) | 0(0.00%) | 0(0.00%) | 10 | 0.03 | 5.32 |
| Customers do not fear using internet banking due to fear of insecurity from hackers | 0.00% | 15(31.2%) | 3(6.25%) | 30(62.5%) | 0.0% | 15 | 0.02 | 4.10 |
| ATMS reduce congestion in banking halls thus enhance ROA | 33(68.75) | 15(31.25%) | 0.00% | 0.00% | 0.00% | 10 | 0.03 | 4.42 |
| Your bank manages to cope with market demands/ development of new products hence improve ROA | 24(50%) | 15(31.25%) | 9(19%) | 0.00% | 0.00% | 15 | 0.02 | 4.60 |
| Your bank continuously improves old products and raise quality of new products | 36(75%) | 12(25%) | 0.00% | 0.00% | 0.00% | 10 | 0.03 | 4.62 |

Table 3. Presents effect of product/service innovations on financial performance. As per the statement that customers are able to receive money on their mobile phones, 100 per cent agreed. Mobile banking for example has greatly enabled customers to have access to funds anywhere they are, more so those in rural areas have great advantage. This in turn has greatly saved time. Customers are also in a position to receive real time updates on transactions executed and incase of concern the customers can get in touch with the bank staffs and get solutions to their enquiries.

Mutua, Oteyo and Njeru, (2013), concluded that mobile banking offers a number of services ranging from account information, which informs the customers on the updates and transactions on their account through their mobile phones. Clients receive short messages on their phones any time they make transactions in their bank accounts. However, on the question as to whether customers do not fear using internet banking due to fear of insecurity from hackers 31.25 per cent agreed, 6.25 per cent remained neutral as 62.5 per cent disagreed. Digital banking despite having greatly improved the financial performance in banks internet banking is causing much fear to customers in terms of insecurity. Banks however need to protect their data from any security threats hence they have come up with various ways to deal with the issue like creating firewall technologies to prevent attacks. Jassal and Sehgal (2013) explored several of technology and security standards required for safe internet banking and to analyze.

**Recommendations**

The study recommended that, e- banking is greatly improving banks efficiency of its operations hence the study recommended that banks which have not invested on current innovations should consider incorporating the new technology as it will increase the firms’ performance. It was advocated that, organizations to always ensure their new products and services, are readily available in the market. Financial institutions should ensure that banking innovations are secured for customers to have confidence in mobile and internet banking.

**Conclusions**

Most commercial banks have concentrated on their profits by creating new products and services which have minimized their operational costs. The commercial banks have sensitized people on the use of non-cash money to smoothen their mobility and conveniences. Internet banking has been made clear to the public on marketing platforms and trained on how to use, which has fasten use of banking services hence positively influence bank performance as the system is automated and prone to less human errors.

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