EFFECT OF INNOVATION STRATEGY ON PERFORMANCE OF COMMERCIAL BANKS IN KENYA

Karanja Ngugi
Lecturer, Jomo Kenyatta University of Science and Technology

Bob Karina
Managing Director and CEO, Faida Investment Bank

CITATION: Ngugi, K. & Karina, B. (2013), Effect of Innovation Strategy on performance of Commercial Banks in Kenya, *International Journal of Social Sciences and Entrepreneurship*, Vol.1, Issue 3, 2013, 1 (3), 158-170

ABSTRACT

Innovation is considered to be a critical requirement for the growth and profitability of organizations. One of the ways to achieving growth and sustaining performance is to encourage and foster innovative practices and creativity internally within the institution. The objective of this paper is to investigate relationship between innovation strategies adopted by commercial banks in Kenya and their performance. Firm's performance is the appraisal of prescribed indicators or standards of effectiveness, efficiency, and environmental accountability such as productivity, cycle time, regulatory compliance and waste reduction. The objective of the study was effect of innovation strategy on performance of commercial banks in Kenya. The author used descriptive research design Primary data was collected from 43 managers in commercial banks using both open ended and closed. Secondary data was obtained from annual reports, websites, journals and libraries. The study found that the banks employed environmental analysis and response to change, the banks employed aggressive anti-competitors marketing campaigns. It was clear that product innovations affected performance of Commercial banks. The study found that product replacement contributed to the bank's profitability, product repositioning contributed to the bank's profitability. The study found that process innovation strategies such as reduction of costs and conformance to regulations contributed to the bank's profitability. The study revealed that technological innovations affected performance of commercial banks. Aggressive anti-competitors marketing campaigns contributed to the bank's profitability more. The study concludes that adoption of innovation strategies affected profitability of the bank. The study concludes that product innovations such as product replacement and product repositioning contributed to the bank's profitability. Product development was important in both the supply of the core product as well as in the support part of any offer. The paper concludes that adoption of innovation strategies affected performance of the bank to a great extent.

Key words: *Innovation, performance, market, product, process, technology, strategy*

Introduction

Innovation involves acting on the creative ideas to make some specific and tangible difference in the domain in which the innovation occurs (Davila et al, 2006). Innovation is defined as the successful implementation of creative ideas within an organization. Strategy is the direction and scope of an organization over the long term which achieves advantage in a changing environment through its configuration of resources and competences with the aim of fulfilling stakeholders' expectations (Oke and Goffin, 2001). Firm's performance is the appraisal of prescribed indicators or standards of effectiveness, efficiency, and environmental accountability such as productivity, cycle time, regulatory compliance and waste reduction. Performance also refers to the metrics regarding how a certain request is handled, or the act of doing something effectively.

Background

Innovation is considered to be a critical requirement for the growth and profitability of organizations. For private sector organizations operating in increasingly competitive market, innovation is often a condition for simple survival. The capability to innovate is ever more viewed as the single most vital factor in developing and supporting competitive advantage (Tidd, 2001). According to Davila, Epstein and Shelton (2009) innovation is a necessary ingredient for sustained success and is an integral part of the business. Much weight has been accorded on building innovative institutions and the management of the innovation progression as necessary elements of institutional survival (Brown, 1997).

Firm's performance is the appraisal of prescribed indicators or standards of effectiveness, efficiency, and environmental accountability such as productivity, cycle time, regulatory compliance and waste reduction. Performance also refers to the metrics regarding how a certain request is handled, or the act of doing something effectively; of performing; using knowledge as notable from just possessing it. It is the result of all of the organisation's operations and strategies (Venkatraman and Ramanujam, 2001).

In today's knowledge economy, investments in intellectual assets are considered more and more to be key strategic elements to maintain a business' growth, profitability and competitiveness (Berry, 2000). For banking organizations operating in increasingly competitive market, innovation is often a condition for simple survival. The capability to innovate is ever more viewed as the single most vital factor in developing and supporting competitive advantage

Innovation in the banking sector aims at developing a change adept organization that anticipates, creates and responds effectively to change in the external and internal environments to increase profit potential. Some of the forces of change that have greatly influenced the banking industry in Kenya include intense competition, regulation and technological advancement.

In today's dynamic and global competitive environment, innovation is becoming more pertinent, mainly due to three major trends: concentrated international competition, disjointed and challenging markets, and assorted and swiftly changing technologies (Wheelwright and Clark, 1992). In many countries, the pace of change in banking industry is dramatic. The banking services providers worldwide are becoming increasingly interrelated. New types of business and corporate strategies are being explored: better market segmentation, industry consolidation, changed delivery channels and expanded product offerings. Information technology (IT) has been established as a key enabler of change. It is also resulting into a driver of change with new products such as telephone banking, mobile banking, electronic banking and ATM banking.

Structure of Banking Industry in Kenya

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), govern the Banking industry in Kenya. The CBK, which falls under the Minister for Finance’s docket, is responsible for formulating and implementing monetary policy and fostering the liquidity, solvency and proper functioning of the financial system. The CBK publishes information on Kenya’s commercial banks and nonbanking financial institutions, interest rates and other publications and guidelines. Banks in Kenya have come together under the Kenya Bankers Association (KBA), which serves as a lobby for the banks' interests and addresses issues affecting its members.

The banking sector is made up of 45 licensed institutions to carry out the business of financial intermediation. They are guided by prudential guidelines issued by the Central Bank of Kenya. Of the 45, 2 are mortgage finance companies and one is non-bank financial institution. Out of the 45 institutions 35 of the commercial banks, most of which are small to medium sized, are locally owned and 10 are foreign owned. Three of the locally owned banks have significant government shareholding. Six of the major banks are listed on the Nairobi Stock Exchange (CBK Bank Supervision Annual Report, 2010).

Statement of the Problem

Rycroft and Kash (1999) claim that innovation requires a process of co-evolution between technology and cultural perspectives where radical innovations are new technologies or new products that fill needs perhaps yet unrecognized; and incremental innovations improve what already exists. Kim and Mauborgne (1999) argue that innovation is concerned with improving the mix of target markets and how chosen markets are best served.

Commercial Banks in Kenya have undertaken some form of incremental innovative initiatives. For example Equity bank has introduced new innovative products aimed at supporting the agricultural sector in Kenya. Among these products is Kilimo Biashara, Mifugo Biashara, Uvuvi Biashara, Warehouse receipting and many others. Some of these banks consider that the cumulative gains in efficiency are much greater over time than those, which come from irregular radical changes. However, many of these short- and medium-term gains are quickly eroded and absorbed into the industry standard and therefore cannot be depended upon as a prerequisite for survival and growth. Banks practice both incremental and radical innovation. In these banks periods of incremental innovation are interspersed when necessary with radical and transformational change. Though the banking industry in Kenya has been operating in a competitive environment, the banks have consistently experienced trajectory growth in terms of number of customer and asset base. It is therefore expected that for these banks to thrive in this competitive environment they must have adopted strategies such as innovation to respond and adapt to the changes and challenges in their operating environment.

The fact that the banking industry environment has been affected adversely by the changing operating environment calling for adoption of innovation strategies to enhance a competitive edge in the markets, Locally, Gitonga (2003) did a study on innovation processes and the perceived role of the CEO in the banking industry. Odhiambo (2008) carried out a research on the innovation strategies at the Standard Chartered Bank. None of these studies have ever focused on the relationship between innovation strategies and performance of the entire banking industry in Kenya.

Research Objectives

i. To find out the whether market innovation strategies affect performance of commercial banks in Kenya?

ii. How do product innovation strategies affect performance of commercial banks in Kenya?

iii. To what extent do process innovation strategies affect performance of commercial banks in Kenya?

iv. How do technology innovation strategies affect performance of commercial banks in Kenya?

Rationale of the study

This article is important to the companies in the banking industry as it brings out the role of innovation strategy in their performance. The results of this study would also be invaluable to researchers and scholars, as it would form a basis for further research. The students and academics would use this study as a basis for discussions on innovation strategies and firm performance. The study would be a source of reference material for future researchers on other related topics; it would also help other academicians who undertake the same topic in their studies.

Literature Review on Innovation Strategies

The significance of having an evidently defined innovation strategy directing the innovation process was recognized by Cooper et al. (2003). According to Tushman and Nadler (2006), strategic management in the banking sector demand that the institutions should have effective systems in place to offset unpredictable events that can maintain their operations and reduce the risks implicated through innovations. According to Davila, Epstein and Shelton (2006) innovation is a necessary ingredient for sustained success and is an integral part of the banking business.

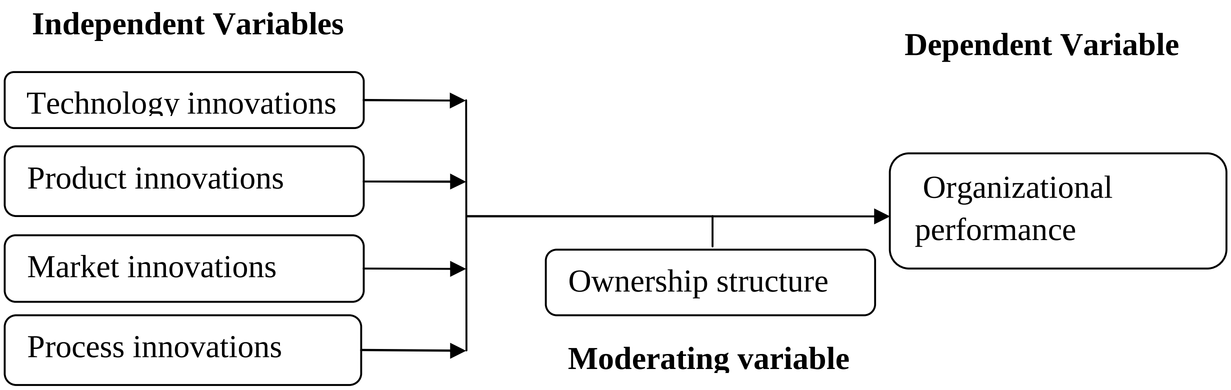
For many banking firms in Kenya, information and communication technology is viewed as potentially capable of helping achieve innovative strategy. The high rate at which organizations are buying mobile phones, computer hardware and software as well as using the Internet for information and communication is evidence of the increasing awareness of information and communication technology in the Kenyan market. The business benefits of using information and communication technology include efficiency and attainment of increased returns. The vast opportunities brought by the Internet to the banking industry have therefore attracted much attention from researchers whose efforts apparently group on certain areas of interest.

With the use of information technology (IT), the banks can use the cross-selling strategies to sell new banking innovations to their existing customer base. It can be seen that bank's adoption of technology changes from improving efficiency of back office banking functions towards improving the service quality in servicing the customers. Such changing strategy demonstrates the situation where banks compete to own the potential customers.

The adoption of short messages services banking both from clients will, if effectively implemented, lead to substantial cost savings by insurers in the areas of telephone calls and personnel time. Product innovation provides the most obvious means for generating revenues (Banking Supervision annual report 2007). Process innovation, on the other hand, provides the means for safeguarding and improving quality and also for saving costs. Improved and radically changed products are regarded as particularly important for long-term business growth

Product innovations enable the banks to increase their brands or products in the market hence create competitive advantage for the organizations; market innovation enables the banks create new markets hence increasing the competitive advantage; process innovation enables the running of the banks' operations thus increasing effectiveness and efficiency while technology innovation will encourage ease of flow of information and fast delivery to the intended persons.

Conceptual Framework



Source: Authors' Schematic 2011

Research Methodology

The study adopted a descriptive research design. This study collected quantitative data from 43 bank managers using a self-administered questionnaire with a five point Likert scaled questions. A pilot study was conducted aimed at determining the validity and reliability of the questionnaire. According to Mugenda and Mugenda (2003), in a research study, the reliability coefficient can be computed to indicate how reliable data are. A coefficient of 0.80 or more implies that there is a high degree of data reliability. The survey instrument was subjected to overall reliability analysis and was found to be highly reliable (Cronbach alpha = 0.918). It was found that the relationship between innovation strategy and performance was highly reliable (Cronbach alpha = 0.906). This is excellent reliability according to Hair *et al.* (2010). Data collected was analyzed by descriptive analysis. In addition, the researcher conducted a multiple regression analysis.

Results, Analysis and Discussion

Market Innovations Strategies

The study established that market innovations affected performance of commercial banks. The study found that the banks employed environmental analysis and response to change, the banks employed aggressive anti-competitors marketing campaigns. Aggressive anti-competitors marketing campaigns contributed to the bank's profitability more.

Product Innovation Strategies

It was clear that product innovations affected performance of Commercial banks. The study found that product replacement contributed to the bank's profitability, product repositioning contributed to the bank's profitability. The respondents indicated that product development was important in both the supply of the core product as well as in the support part of any offer and they also agreed that the bank's product development strategy aimed to hit many singles.

Process Innovation Strategies

The study found that process innovation strategies such as reduction of costs and conformance to regulations contributed to the bank's profitability. It was deduced that use of technology innovation promoted a friendly and helpful staff hence customer satisfaction and that the innovations ensured that the services given to customers were of high quality.

Technology Innovation Strategies

The study revealed that technological innovations affected performance of commercial banks. The study found that ATM's, internet banking and new technology development contributed to the bank's profitability.

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.908[a]	.825	.289	.65323

The four independent variables that were studied, explain only 82.5% of the performance of commercial banks in Kenya as represented by the R^2. This therefore means that other factors not studied in this research contribute 17.5% of the performance of commercial banks in Kenya.

ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	2.534	2	1.267	54.455	.024[a]
	Residual	9.307	40	2.327		
	Total	3.465	42			

The significance value is .024 which is less that 0.05 thus the model is statistically significance in predicting how technological innovations, product innovations, market innovations and process innovations affect the performance of commercial banks in Kenya. The F critical at 5% level of significance was 3.23. Since F calculated is greater than the F critical (value = 54.455), this shows that the overall model was significant.

Coefficient of determination

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	**Std. Error**	**Beta**		
1	(Constant)	1.121	1.223		2.917	.0367
	Market Innovations Strategies	.210	.104	.157	3.081	.0188
	Product Innovation Strategies	.180	.145	.087	2.578	.0267
	Process Innovation Strategies	.396	.204	.155	2.960	.0451
	Technology Innovation Strategies	.722	.224	.512	3.229	.0034

The researcher conducted a multiple regression analysis so as to determine the relationship between performance of commercial banks in Kenya and the four variables. As per the SPSS generated table, the equation ($\mathbf{Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \varepsilon}$) becomes:

$Y= 1.121+ 0.210\ X_1+ 0.180X_2+ 0.396\ X_3+ .722X_4$

According to the regression equation established, taking all the four innovation strategies into account constant at zero, performance of commercial banks in Kenya will be 1.121. The data findings analyzed also shows that taking all other independent variables at zero, a unit increase in technology innovation strategies will lead to a 0.722 increase in performance of commercial banks in Kenya. A unit increase in process innovation strategies will lead to a 0.396 increase in performance of commercial banks in Kenya; a unit increase in market innovations strategies will lead to a 0.210 increase in performance of commercial banks in Kenya and a unit increase in product innovation strategies will lead to a 0.180 increase in on performance of commercial banks in Kenya. This infers that technology innovation strategies contribute more to the performance of commercial banks in Kenya followed by the process innovation strategies.

At 5% level of significance and 95% level of confidence, technology innovation strategies had a 0.003 level of significance, process innovation strategies had a 0.045 level of significance, market innovations strategies showed a 0.0188 level of significant and product innovation strategies showed a 0.0267 level of significant hence the most significant factor is technology innovation strategies. The t critical at 5% level of significance at k = 4 degrees of freedom is 2.245. Since all t calculated values were above 2.245 then all the variables were significant in explaining the performance.

Conclusions

The study concludes that adoption of innovation strategies affected profitability of the bank. Further, the banks employed market innovations such as environmental analysis and response to change and aggressive anti-competitors marketing campaigns that greatly affected their performance. Aggressive anti-competitors marketing campaigns contributed to the bank's profitability.

Secondly, the study concludes that product innovations such as product replacement and product repositioning contributed to the bank's profitability. Product development was important in both the supply of the core product as well as in the support part of any offer. In addition, the study concludes that process innovation strategies such reduction of costs contributed to the bank's profitability and conformance to regulations contributed to the bank's profitability. Use of technology innovation promoted a friendly and helpful staff hence customer satisfaction. Innovations ensured that the services given to customers were of high quality.

Recommendations

Central Bank of Kenya should create an enabling environment that will enhance innovations in the commercial banks so that they realize the full benefits of innovation strategies. Through compliance with the regulations and policies the commercial banks will realise performance as a result of process, product, market and technology innovations among others which without a proper policy the telecommunication commercial banks would not operate effectively in the market to realize performance. For all the commercial banks to realize higher performance, increase number of customers, for their business to grow further and also for them to invest more they should embrace the adoption of market innovative strategies.

The companies should also strive to ensure product range extension, product replacement, product improvement, product repositioning and new product introduction to enable the companies to be more productive, to grow faster, to invest more and also to earn more performance. The product development strategies can be effectively adopted if there are quality systems in place, there is good information flow, there is specialization and also if the management fully supports the competitive strategies. The power of product innovation in helping companies retain and grow competitive position is indisputable. Commercial banks should ensure new products introduction, reduction of costs, improved innovation process and conformance to regulations are used to influence performance of commercial banks. This will help the tap into customers' needs so well that new products generate their own source of marketing momentum. The commercial banks should establish that there are staffs available in good time to serve the customers efficiently, use of technology innovation to promote a friendly and help staff hence customer satisfaction, less time is required at the service point due to innovations in the company and the innovations ensure that the services given to customers are of high quality. Technology innovation encourages ease of flow of information and fast delivery to the intended persons. For efficient adoption of technology innovation strategies, there should be reliable infrastructure, enough financial resources; and the staff should be equipped with adequate skills and knowledge on the new technology through regular training in order to ensure that they do not resist the adoption of the new technology in the commercial banks.

References

Berry, D.B., (2000), Competitive Viability in Banking: Scale, Scope and Product Mix Economies, *Journal of Monetary Economics* Vol. 20 (4) pp. 19-28

Brown, J.S. (1997), *Seeing Differently, Insights on Innovation*, Harvard Business School Press, Boston, MA.

CBK Bank Supervision Annual Report, 2010

CBK Banking Supervision annual report 2007

Cooper, R.G., Scott, J.E., Kleinschmidt, E.J. (2003a), "Optimizing the stage-gate process: what best-practice companies do I", *Research Technology Management*, Washington, DC, Vol. 45 No.5, pp.21-7

Davila, Tony; Marc J. Epstein and Robert Shelton (2006). *Making Innovation Work: How to Manage It, Measure It, and Profit from It*. Upper Saddle River: Wharton School Publishing. ISBN 0-13-149786-3.

Davila, Tony; Marc J. Epstein and Robert Shelton (2006). *Making Innovation Work: How to Manage It, Measure It, and Profit from It*. Upper Saddle River: Wharton School Publishing. ISBN 0-13-149786-3.

Gitonga Timothy (2003) *Innovation Processes And The Perceived Role Of The Ceo In The Banking Industry*, Unpublished MBA project. University of Nairobi.

Hair, J.F., Black, W.C., Babin, B.J., Anderson, R.E., Tatham, R.L. (2010), *Multivariate Data Analysis*, 7th ed., Prentice-Hall, Upper Saddle River, NJ, .

Kim, W.C., and Mauborgne, R. (1999), "Strategy, value innovation, and the knowledge economy", *Sloan Management Review*, Spring, Vol. 40 No.3, pp.41-54.

Mugenda, O. M and Mugenda, A. G (2003). *Research Methods:* Quantitative and Qualitative approaches. Nairobi, Acts Press.

Odhiambo Gordon Omollo (2008) *Innovation Strategies at the Standard Chartered Bank;* An Unpublished MBA project. University of Nairobi

Oke, A., and Goffin, K. (2001), *Innovation management in the service sector,* Management Focus, summer issue.

Rycroft, R.W., Kash, and D.E. (1999), “Managing complex networks: keys to 21st century innovation success”, *Research and Technology Management*, Vol. 42 No.3, pp.13-18.

Tidd, J., Bessant, J., and Pavitt, K. (2001), *Managing Innovation: Integrating Technological, Market and Organisational Change*, Wiley, Bognor Regis.

Tushman G. and Nadler S. (2006), Relative strengths and weaknesses of small firms in innovation, *International Small Business Journal*, Vol. 16 No.3, pp.88-94.

Venkatraman J. and Ramanujam G. (2001), *Structural Cybernetics: An Overview*, Ridgefield, New York, NY, .

Wheelwright, S.C., and Clark, K.B. (1992), *Revolutionizing Product Development – Quantum Leaps in Speed, Efficiency, and Quality,* The Free Press, New York, NY,