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Influence of Investment Diversification on Profitability of Commercial Banks in Nakuru Town, Kenya

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Abstract:
Background: *Commercial banks have in the recent past been recording fluctuating profits. In the wake of the hitherto unstable profitability posted by these banks in Kenya, they have diversified their financial activities beyond the hitherto banking scope. The objective of this article was to determine the influence of investment diversification on banks' profitability. The research was guided by both the resource dependency and agency theories.*
Materials and Methods: *A descriptive research design was adopted. The study population constituted 38 branch managers working with commercial banks operating in Nakuru town. A census design was adopted where all members of the study population constituted the unit of analysis and unit of observation. A structured questionnaire was used to collect primary data from the respondents. The Statistical Package for Social Sciences was used to analyze data. Descriptive and inferential statistics were used in the analysis.*
Results: *The investment diversification was found to relate with profitability of commercial banks significantly($r = 0.442$; $p = 0.035$).*
Conclusion:*It was concluded that commercial banks diversified their investments particularly in form of risk-free government securities, real estate, mutual funds and co-ownership in other firms.*
Key Word:*Agency theory; commercial banks; investment diversification; modern portfolio theory; profitability.*

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I. Introduction

Background of the Study:The dynamics in the financial industry particularly, the banking sector, have obliged banking institutions to embrace changes that can essentially put them financially afloat. The banking sector especially in emerging markets has lately experienced a decline in its traditional activities. This has necessitated banks, mostly leading commercial banks, to diversify into new business strategies which include financial activities[1].There are various reasons that necessitate firms to diversify. Organizations can diversify in order to realize growth, be more effectively utilized existing resources and capabilities, to evade undesirable or unattractive industry environment, and also to utilize surplus cash flows. In the banking sector, diversification is witnessed when banking institutions shift to non-interest-based activities with the view of improving their financial performance.

A survey of commercial banks in countries across East Asia and Latin America indicated that diversification gains are more when compared to the financial risks occasioned by increased exposure to non-interest income[2]. Majority of commercial banks still depend on traditional banking as the source of their income. This notwithstanding, a considerable number of banks in these emerging countries has diversified into investment banking-type activities, fee-based business and related activities[3]. It is stated that competition in the banking sector reduced profitability of commercial banks; a factor that necessitated them to identify other avenues to earn profit through diversified financial activities, which did not fall under the purview of core banking.

In Ghana, commercial banks have shifted from their normal line of business which encapsulated mobilizing deposits and advancing credit facilities to other financial non-interest earning intermediation services which include the provision of financial guarantees, and derivative arrangements among other services[4]. It is further indicated that Ghana has witnessed drastic shifts in its financial sector and banking industry since its liberalization in the 1980's. Some of the notable changes include increase in the number of banks, and diversification of products and services offered by these financial institutions[4].

In Rwanda, banks use diversification in order to remain competitive in the market. Large diversified banks are dominant in the country's economy. Banks take advantage of new technologies, to develop diversified

product portfolios and to venture into new markets[5].The financial performance of commercial banks in Kigali is influenced by how well loans are managed since they are the main source of income[6].

The Kenyan banking sector has witnessed volatile interest rate margins and profitability[7]. This has resulted from stiff competition in the industry. The situation has been aggravated by the interest rate capping that was introduced by the Central Bank of Kenya (CBK) in 2016 with the object of rescuing borrowers from hitherto exorbitant interest rates charged by banking institutions. However, this was to the detriment of commercial banks that resultantly experienced plummeting income from interest[8]. The interest rates on loans which were capped at a maximum of 14.5% led to a decline in credit extended to borrowers from an average of17.7% in August, 2016 to 13.69% in December 2016[8].

According to Chepkorir, commercial banks in Kenya have diversified their portfolio with the object of enhancing their financial performance[9]. Banks have ventured into real estate investments, bancassurance, and also mobile banking. Real estate investment is underscored to be very critical in improving the financial performance of local banking institutions particularly commercial banks. However, there is limited reach of real estate investment amongst listed commercial banks in Kenya. It is documented that business diversification has substantively affected performance of commercial banks in the country. The foregoing notwithstanding, the precise effect is dependent on the size of the banks with small-sized banks witnessing the most significant improvement on their financial performance resulting from business diversification[10].

Statement of the Problem:Commercial banks have in the recent past been posting fluctuating profits particularly after the introduction of interest rate capping. The introduction of interest rate capping in 2016 implies that commercial banks in Kenya are advancing credit at a maximum of 4% above CBR[8]. The interest rate caps have in turn limited the income commercial banks get from interest charged on loans. Granted that the primary source of revenue for commercial banks is the interest accruing from extended credit facilities, the interest rate caps have, therefore, affected profitability of these financial institutions. According to the CBK, the banking sector recorded 5.03% decrease in pre-tax profit from Ksh. 141.1 billion in December 2014 down to Ksh. 134.0 billion in December, 2015[11]. The banks' revenue increased by 9.1% in 2015 while at the same time, expenses rose by 16.3%, thus depicting a decline in profitability. Against this backdrop, it is rational for these financial entities to diversify their financial activities. Therefore, it was imperative to conduct an empirical study with the primary objective of evaluating the influence of financial activity diversification on profitability of commercial banks in Kenya.

Objective:To analyze the influence of investment diversification on profitability of commercial banks in Nakuru town, Kenya

Hypothesis:**H_0:** Investment diversification has no statistically significant influence on profitability of commercial banks in Nakuru town, Kenya.

II. Literature Review

Resource Dependency Theory: The theory was developed by Pfeffer and Salancik[12].It states that a corporation is an open system which is dependent on contingencies in the external environment. The theory explains the behaviour of an organization in terms of its actions in decision making and the results of decision making and its organizational structures. The theory also explains how different organizational structures emerge. It, further, holds that the environment is endowed with critical resources which are needed by the organization. It is, therefore, important for firms to identify the critical resources it requires for its survival and its ability to continue functioning without those particular resources[13].

In relation to the theory organizations strive to reduce uncertainty which is brought about by the environment. The extent of uncertainty varies depending on the distribution of critical resources in the environment. Dependency is brought about by the fact that there are actors who control the critical resources and there are other actors who need the same resources which ultimately leads to various relationships of dependency. If an organization has a vast reserve of resources which are within its controls the lesser the dependency and conflicts with the actors[14].

It is stated that firm mergers are seen as strategies for reducing uncertainty and controlling resources while vertical integration is a way of extending an organizational control over resources[15]. Horizontal integration on the other hand, is a way of extending dominance of resource controllers. The other strategies used to reduce uncertainty and managing environmental demands include use of interlocking boards of directors and supervisory boards of banks. The theory holds that organizations should try to relate themselves with the environment and manipulate it for their own benefit. The theory greatly explains and gives substantial support to the formation of inter-organizational relationships though it does not explain its maintenance and survival[15].

The theory assumes that an organizations dependence on vital and critical resources influences the actions of the organization and that the organizational decisions can be explained depending on the dependency situation. Additionally, the theory does not suggest that the environment and dependency on critical resources directly influences organizational behaviour behind the actors back but make assumptions about actors and their

relation to the environment. The theory also assumes that there is bounded rationality which takes in to account the limits in formulating and solving complex problems and in receiving, storing, retrieving and transmitting information. The theory focused more on the importance of the environment and resource use in internal processes and failed to address resource gain through internal processes[16].

Commercial banks have taken advantage of the changes in their industry and embraced financial innovations in technology. The changes in financial organizations have enabled the banks to be able to expand their services to include mobile banking and ATM services. Banks have also reduced their dependence on the traditional banking activities to include investments in non-interest income activities such as, offering insurance services as well as investing in real estate. Commercial banks should also be restructured so as to be able to acquire the critical resources required for their survival.

Agency Theory: The agency theory was proposed by Jensen and Meckling in 1976[17]. The theory states that there existed a conflict when the interests of the agent(s) fail to match the interest of the principal(s). This occurs when agents, say managers of a firm, pursue individual interests to the detriment of the good of the organization. In a principal-agent relationship, conflicts are often imminent particularly when the interest of both parties fails to be harmonized. Agency conflict is asserted to result in agency costs of debt and equity. Agency costs of debt include the opportunity cost of debt resulting from the impact of debt on investment decision, monitoring costs occasioned by incentive effects linked to high leverage, bonding costs, amongst others[18]. Interest accruing from debt and the incentive to seek additional capital for investment lead to agency cost of debt.

The theory emphasizes on the reduction of the problem that arises as a result of separation of owners and managers. The theory assists in implementing the various governance mechanisms so as to control the agent's actions in jointly held corporations[19]. The theory, further, provides a way which could be applied to reduce the apparent agent principal problem. A contractual agreement between the principal and the agent is proposed in which the incentive structure is clearly outlined[20]. In addition, the theory recognizes an organizations need to make profits and maximize its value which can only be realized when there is proper coordination and teamwork among those involved in the firm.

The agency theory has laid too much emphasis on agent side of the principal and agent conflict and opines that the problem can also arise from the principal's side[21]. It is further postulated that the theory is unconcerned about the principals who exploit and deceive the agents. The theory only emphasizes on the agency cost and the realignment of both parties interests to curb the agency problem[21]. However, it is propounded on the theory and recommended the use of agent's motivation, equitable compensation, risk averseness and time preference to curb the principal agent problem[22].

The theory further, assumes a contractual relationship between the two parties for an unlimited future period, where the future is uncertain. It also assumes that a contractual relationship can eliminate the agency conflict but in real sense it faces hindrances such as transaction cost, information asymmetry and fraud. Moreover, the theory tends to ignore the competence of the managers and only views them as opportunistic[23].

When a firm posts superior performance, the agency cost of debt financing is reduced[24]. The profitability of commercial banks is highly dependent on the input of the staff entrusted to run the bank on behalf of shareholders. Conflict is likely to occur if and when the staff particularly the managers pursues their individual goals at the expense of the interest of shareholders. Wrongly reporting the financial position of banks particularly in regard of inflating the profitability with the view of being recognized and rewarded, managers are likely to imperil the institutions' financial sustainability. This is because there are many factors that are hinged on the profits made by an entity. These include awarding of bonuses, salary increments and issuing of dividends among others. In the event the foregoing takes place against the backdrop of banks recording less profit than the one reported by the management, the financial sustainability of such banks would be endangered.

Conceptual Framework: The study was guided by two variables as shown in Figure 1. These were independent and dependent variables as represented by investment diversification and profitability of banks respectively. Investment diversification was parameterized by real estate investments, government securities, shares, and mutual funds. On the other hand, the indicator for profitability was return on investment. It was hypothesized that investment diversification influenced profitability of commercial banks in Nakuru town, Kenya.

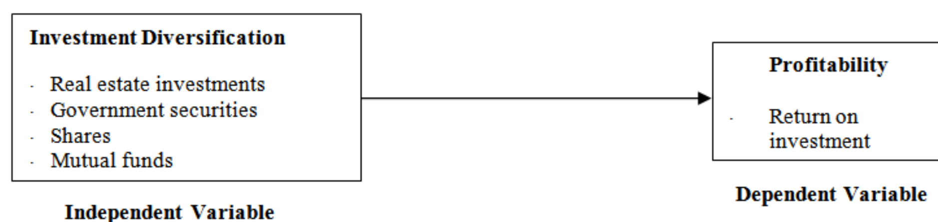

Figure 1: Conceptual Framework

III. Material And Methods

Under this section is the study design, study location, target population, unit of observation and its determination, research instrument, validity and reliability testing, and methods for data analysis.

Study Design:A descriptive research design and quantitative approachwere adopted. The rationale of opting for this research design was premised on the fact that, the study sought to a study specific phenomenon, that is, financial activity diversification and profitability of commercial banks. The foregoing characterizes descriptive studies[25].

Study Location: The study was conducted in Nakuru town which is the third largest urban area by population in Kenya. It is a host of more than 30 branches of licensed commercial banks. At the time of collecting data for this article, the town had 38 branches of all the three tiers of commercial banks in Kenya. Out of the 42 functional banks in Kenya, the town had at least 27 banks.

TargetPopulation: Target population is described as the aggregate of individuals, entities or subjects sharing common or similar characteristics in relation to a given study[26]. This study targeted the branch managers working with commercial banks in Kenya. The study population which is defined as the population to which the researcher has access to[27], constituted 38 branch managers working with commercial banks in Nakuru town. The choice of branch managers was premised on the fact that they were believed to be the most conversant with issues regarding investment diversification and profitability of their respective banks.

Study Duration: The study was conducted over a period of approximately 6 calendar months lapsing October 2020.

Unit of Observation: 38 branch managers of commercial banks in Nakuru town.

Unit of Observation Determination: The study used census design to come up with the unit of observation comprising of the participants of the study. A census design is defined as an approach whereby all members of the study population take part in a given study, and as such constitute both the unit of analysis and observation[27]. The choice of this design was informed by the relatively small study population (38 branch managers). The census approach enhanced the generalization of findings to the target population.

Research Instrument: A structured questionnaire was used to collect data from the branch managers. It is opined that questionnaires are the most appropriate tools for collecting data from a relatively large number of dispersed respondents[28]. The questionnaire was structured in such a way that it facilitated collection of data pertinent to the study objectives. More so, the questionnaire enabled collection of data on a 5-point Likert scale. The collection of secondary data was facilitated by data collection sheets with clearly outlined various parameters of profitability.

Pilot, Validity and Reliability Testing: The questionnaire was subjected to a pilot study before it was used to facilitate collection of data for the main study. This minor study was conducted among 4 (10% of the sample size) randomly selected branch managers working with commercial banks in Naivasha town, Kenya. The rationale of conducting the pilot study was to determine both the validity and reliability of the research questionnaire.

A valid instrument is one that measures what it purports to measure[29]. The present study sought to determine the content validity of the research instrument. This was achieved through consultation with the assigned university supervisor since content validity cannot statistically be determined. The supervisors ascertained that the data items captured in the questionnaire were sufficient in facilitating collection of data that could address financial activity diversification of commercial banks.

Reliability is a measure of the internal consistency of a research instrument[27]. This implies that a reliable instrument can be administered on different populations with similar characteristics and return similar results. The study adopted the Cronbach's alpha coefficient to test the reliability of the research questionnaire. The reliability threshold was alpha values equal to or greater than 0.7 ($\alpha \geq 0.7$). The investment diversification variable returned alpha = 0.781 which implied that it attained the minimum reliability threshold.

Statistical Analysis: The researcher first verified the completeness of the filled questionnaires to ensure that only the appropriately filled ones were considered in the analysis. The Statistical Package for Social Sciences (SPSS) Version 24 software was used to facilitate data analysis. Descriptive statistics and inferential statistics were used in the analysis. Descriptive statistics encompassed measures of distribution (frequencies and percentages) measures of central tendencies (means) and measures of variation (standard deviations). Inferential statistics took the form of Pearson's correlation coefficient and simple linear regression. The null hypothesis was tested at 95% confidence level. The t-test was employed where p-value less than 0.05 resulted in rejection of the null hypothesis while p–value greater than 0.05 implied that the null hypothesis would not be rejected. The results of the analyses were presented in tables. The following simple linear regression model was adopted: $\mathbf{Y = \beta_0 + \beta X + \varepsilon}$ where **Y**, **X**, **ε**, and **β** represented profitability, investment diversification, error margin, and regression coefficient of the independent variable respectively.

IV. Results, Interpretations and Discussion

This section presents the results, interpretations, and discussion in relation to the data collected pertinent to investment diversification and profitability of commercial banks operating in Nakuru town. The first part outlines the response rate. The second part presents the descriptive findings for all study variables. The last part covers the results of correlation analysis.

Response Rate: Questionnaire return rate or response rate is described as the actual number of questionnaires collected having been filled accordingly vis-à-vis the total number of questionnaires initially issued to the respondents. In survey studies, akin to the present one, the recommended response rate is 75%[30]. In the context of this study, a total of 38 questionnaires were issued to the branch managers in charge of the 38 branches of commercial banks operating in Nakuru town. The number of questionnaires that were filled and duly collected totaled 29. Therefore, the return rate as shown in Table 4.1 was 76.32% and was deemed acceptable. The relatively high response rate was attributed to the fact that the data collection was carried out by the researcher in person who explained to the branch managers the importance of taking part in the study.

Descriptive Statistics for Investment Diversification: The descriptive results shown in Table 1 indicated that most (79.3%) of the surveyed branch managers concurred that commercial banks invested in real estate. A section of the managers (10.3%), however, disputed the assertion. It was revealed that majority (96.5%) of the managers admitted that the banks invested in government securities such as treasury bills and bonds. The foregoing view, nevertheless, was disagreed by 3.4% of the surveyed managers. The study also established that 82.7% of the respondents agreed that the banks invested in other firms where the banks owned a significant number of shares. A number of managers (13.8%) were, nevertheless, not sure whether the banks invested in other firms where the banks owned a significant number of shares or not. It was further noted that 69% of the selected managers believed that the banks had invested in mutual funds. The foregoing assertion was disputed by 10.3% of the branch managers. A significant number (20.7%) of the managers were unsure of the view that the banks had invested in mutual funds or not.

The study further ascertained that the branch managers agreed that commercial banks invested in real estate (mean = 4.00). Their views in respect of the said proposition were largely similar (std dev = 0.434). It was further noted that the managers averagely admitted that the banks had invested in government securities (4.55), and that the banks had invested in other firms where they owned a significant number of shares (mean = 4.24). With regard to the stated propositions, the managers held closely related views (std dev< 1.000). It was, moreover, found that the managers admitted that the banks invested in mutual funds (mean = 3.72). The managers' opinions regarding this assertion were significantly diverse (std dev = 1.066).The results of the study mirrored past recommendations that commercial banks should be confident in portfolio diversification[31].

Table 1: Descriptive Statistics for Investment Diversification

	N	SA %	A %	NS %	D %	SD %	Mean	Std. Dev.
Commercial banks invest in real estate	29	37.9	41.4	10.3	3.4	6.9	4.00	1.134
Our bank has invested in government securities such as treasury bills and bonds	29	65.5	31.0	0	0	3.4	4.55	.827
Our bank has invested in other firms where it owns a significant number of shares	29	44.8	37.9	13.8	3.4	0	4.24	.830
Our bank has invested in mutual funds	29	20.7	48.3	20.7	3.4	6.9	3.72	1.066

Descriptive Statistics for Profitability of Commercial Banks: The secondary data on profitability sourced from financial reports of commercial banks were analyzed. The panel data spanned over three years, that is, 2015, 2016, and 2017. Year 2015 was prior to introduction of interest rate caps by the Central Bank of Kenya. Year 2016 was partly affected by the interest rate caps which came to effect on September 2016. On the other hand, year 2017 was entirely affected by interest rate capping. The results to this effect were presented in form of frequencies. However, out of the 29 commercial banks whose branch managers participated in the study, only financial reports of 23 banks for the years under study were accessed and subsequently analyzed.

According to the results of the analysis shown in Table 2, it was found that a total of 21.7% of the surveyed banks made a loss in the year 2015. In the same year, 13.0% of the banks reported net profit after taxation of less than Ksh 100 million while 21.7% made net surplus of between Ksh 100 million to Ksh 999 million. The majority (34.8%) of the banks registered net profit of between Ksh 1 billion and Ksh 9 billion. Only 8.7% of the banks reported net profits of Ksh 10 billion and above. The foregoing results showed that generally the surveyed banks reported profitability in 2015 probably due to high uptake of credit facilities coupled with relatively high lending rates.

It was also revealed that 17.4% of the banks reported significant losses. Furthermore, 17.4% of the banks registered less than Ksh 100 million profits as at the end of 2016. On the same note, 26.1% reported

surpluses of between Ksh 100 million and Ksh 999 million. The most (30.4%) of the banks registered profits ranging from Ksh 1 billion to Ksh 9 billion over the same year whilst only 8.7% reported net profit after taxation and other items of Ksh 10 billion and above. There was a possibility that the large banks were able to diversify their revenue sources and counter the reduction in revenue occasioned by interest rate capping in the last quarter of 2016.

The study further examined the net profit or loss for the surveyed banks in the financial year 2017. It was established, as illustrated in Table 2 that 21.7% of the banks incurred losses. This was believed to have been occasioned by interest rate capping, which according to CBK (2016) was pegged at a maximum of 4% over the Central Bank Rate (CBR). The full effect of the capping started being felt in 2017. Similarly, this could have also been attributed to the fact that the core revenue of commercial banks is obtained from corporate and individual lending especially by smaller banks. In the same year, 17.34% of the banks reported net surpluses of less than Ksh 100 million while 26.1% registered profit ranging from Ksh 100 million to Ksh 999 million. Approximately a third of the banks reported profits of between Ksh 1 billion and Ksh 9 billion. Moreover, it was revealed that 8.7% of the banks were able to realize Ksh 10 billion profits and above.

Table 2: Net Profit/Loss Recorded by Commercial Banks in 2015, 2016, and 2017

	2015		**2016**		**2017**	
Net Profit/Loss	**Frequency**	**%**	**Frequency**	**%**	**Frequency**	**%**
Loss	5	21.7	4	17.4	5	21.7
Less than 100 million	3	13.0	4	17.4	4	17.4
100 - 999 million	5	21.7	6	26.1	6	26.1
1 - 9 billion	8	34.8	7	30.4	6	26.1
10 billion and above	2	8.7	2	8.7	2	8.7
Total	**23**	**100.0**	**23**	**100.0**	**23**	**100.0**

Relationship between Investment Diversification and Profitability: Pearson's product moment correlation coefficient was used to determine the relationship between investment diversification and profitability of commercial banks operating in Nakuru town, Kenya. According to the results shown in Table 4, it was found that there was a positive, moderately strong and statistically significant relationship between investment diversification and profitability of commercial banks ($r = 0.442$; $p < 0.05$) at 95% confidence level. The results meant that there was a likelihood of substantively increasing profitability of the banks through investment diversification. Diversification of commercial banks' investments in viable projects such as mutual funds, real estate and government securities was likely to enhance profitability. To some extent, these findings resonated with Rop et al.'s (2016) results which indicated that various investments under survey were strongly and significantly correlated with financial performance of commercial banks in Kenya.

Table 4.7: Correlation between Investment Diversification and Profitability

		Profitability
Investment Diversification	Pearson Correlation	.442*
	Sig. (2-tailed)	.035
	N	23

***. Correlation is significant at the 0.05 level (2-tailed).**

V. Conclusions and Recommendations

The study concluded that the commercial banks diversified their investments. The investments were in form of risk-free government securities, real estate, mutual funds and co-ownership in other firms. This enabled the banks to record profits.It was recommended that the commercial banks in Nakuru town should carry out risk analysis before committing funds to any project. Investment diversification was established to be important in enhancing profitability. Therefore, it was found to be critical for the banks to consider the viability of various investment ventures before allocating them capital.

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