THE INTERNATIONAL JOURNAL OF BUSINESS & MANAGEMENT

Influence of Product Innovation Practices on Financial Performance of Tier III Commercial Banks in Kenya

Micheni Nkatha Matilda
Student, Department of Business and Economics, Multimedia University of Kenya, Kenya
Dr. Dorcas Kerre
Lecturer, Department of Business and Economics, Multimedia University of Kenya, Kenya
Dr. Michael Makau
Lecturer, Department of Business and Economics, Multimedia University of Kenya, Kenya

Abstract:
Tier III banks in Kenya have been faced with the risk of collapse due to poor innovative practices, low asset quality, inadequate capitalization, weak risk management practices, and a lack of liquidity. The banks face several struggles competing with large banks due to limited resources, lack of economies of scale, and inadequate innovative practices. By embracing innovative practices, these banks will develop and offer new products and services that meet the evolving needs of their customers, differentiate themselves from larger banks, and create value for their shareholders. The main objective of the study was to examine the influence of product innovation practices on the financial performance of Tier III Commercial Banks in Kenya. The study adopted a descriptive research design. The population was all twenty-one (21) Tier III banks listed according to CBK categorization as of 1st February 2023. The census technique was adopted to encompass all the bank managers of the branches based in Nairobi County. The data was collected from both primary and secondary data. Primary data was collected using questionnaires, whereas secondary data was collected using data collection sheets for a period of 3 years (2020-2022). The study found that product innovation practices have a positive and significant effect on the financial performance of tier III commercial banks. The study recommended that tier III commercial banks in Kenya should enhance the adoption of innovation practices in order to improve their financial performance.

Keywords: *Product innovation practices, financial performance*

1. Introduction

Financial performance is a critical aspect of an organization's overall health and sustainability, as it reflects the efficiency and effectiveness of its operations and its ability to meet the expectations of stakeholders (Hertog & Huizingh, 2019). In Europe, although Tier III commercial banks have faced significant challenges, such as lower loan demand and increased regulatory scrutiny, their annual growth rate has hovered around 1.5% to 2%(SP Global, 2022). According to Baker et al. (2023), these banks have adopted open banking and RegTech solutions as key innovation practices. The implementation of the *Revised Payment Services Directive (*PSD2) directive in Europe has been pivotal, enabling the banks to offer new financial products and services by allowing third-party developers to integrate with their systems (SP Global, 2022). This approach has resulted in a 30% increase in its user base and a 15% rise in profitability (Baker et al., 2023). These innovation practices have enabled European Tier III banks to maintain competitive advantages and achieve steady financial growth despite a stringent regulatory environment.

According to Wambua, Namusonge and Odhiambo (2022), the adoption of product innovation practices by Tier III commercial banks in Africa has its roots in the continent's unique financial landscape, where traditional banking infrastructure often falls short in reaching large segments of the population. Further, Donkor et.al (2018) assert that the widespread use of mobile phones has provided an early catalyst, leading to the development of mobile banking and mobile money services that bypass the need for physical branches. Moreover, collaborations with fintech companies have accelerated this phenomenon, allowing banks to integrate advanced technologies such as blockchain and artificial intelligence to enhance security and personalize services (Donkor et.al. 2018).

Nigeria's Sterling Bank has leveraged the benefits of innovation practices through partnerships and digital services. The bank has partnered with Demica, a UK-based fintech, to introduce a supply chain finance product in collaboration with Afreximbank to improve access to trade finance for African SMEs (Uford, 2018). Further, a collaboration with Wragby Solutions has enhanced its digital transformation efforts. These partnerships and collaborations have led to a 35% increase in digital transaction volumes within a single year (Africa Development Bank Group, 2021).). The expansion has been a key driver behind the bank's 15% growth in total assets, which rose from NGN 1.1 trillion in 2019 to NGN 1.26 trillion in 2020.

In Kenya, there are 21 tier III commercial banks that control a total of 8.4% of the industry's market share (CBK, 2022). Through the integration of digital banking solutions and automated processes, the banks have experienced streamlined operations, reduced costs, and provided more convenient services to their customers. For instance, the adoption of mobile and internet banking platforms has resulted in increased customer deposits and transaction volumes (Resa, Mithi & Kosgei, 2022). Automated systems for tasks such as loan processing and customer service have resulted in reduced operational costs and improved service delivery times (Resa, Mithi & Kosgei, 2022). This efficiency gain is reflected in the increased profitability of these institutions. In 2022, the combined net income of Tier III banks increased by 18%, rising from KES 6.1 billion in 2021 to KES 7.2 billion, according to the Central Bank Annual Report (2022). In addition, Tier III commercial banks have explored the strategic development of new financial products, which has expanded their market reach and revenue streams (Wambua, Namusonge & Odhiambo, 2022). By creating tailored products that meet the needs of local markets, such as micro-loans and savings accounts for small businesses and low-income customers, the banks have attracted a larger customer base and increased their loan portfolios (Kenya Bankers Association, 2022).

1.1. Statement of the Problem

The financial industry in Kenya has witnessed significant changes and increased competition, making it difficult for banks to perform optimally (Gudmundsson, Kisinguh & Odongo, 2019). Specifically, the financial performance of Tier III commercial banks, which represent a crucial segment of the banking sector catering to niche markets and smaller enterprises, is increasingly under scrutiny. Despite their importance, these banks are facing significant challenges in maintaining profitability and competitiveness (Nwankwo & Fagbemi, 2017). Further, tier III commercial banks have continued to report poor performance due to factors such as limited scale, narrow customer base, and constrained resources (Kamau & Muturi, 2019). Moreover, Musau and Omwansa (2016) explain that these banks face challenges in terms of smaller market presence, limited customer bases, restricted access to funding, high operation costs, and the alignment of new technologies with existing banking systems. Their narrow customer base results in reduced transaction volumes and lower fee income (Gudmundsson, Kisinguh & Odongo, 2019). Additionally, their limited product offerings and risk management capabilities contribute to higher non-performing loans and credit losses, impacting profitability negatively.

Several Tier III banks in Kenya have collapsed. For example, Chase Bank Kenya was placed under receivership in 2016 due to liquidity problems and mismanagement (CBK, 2016). Further, Imperial Bank Limited faced massive fraud committed by its leadership through illegal deals and was under statutory management from October 2015 before its resolution in 2021 (Business Daily Africa, 2021). Moreover, Dubai Bank Kenya faced liquidity challenges and was also placed under receivership. These cases demonstrate the difficulties faced by Tier III banks in Kenya, leading to their collapse. Thus, the adoption of innovation practices would be an ideal strategy to salvage the adversely affected tier III commercial banks in Kenya.

A study by Adekunle (2021) on product innovation practices and their impact on financial performance in Nigeria found a significant positive relationship between product innovation practices and financial performance in Nigerian manufacturing firms. However, the generalizability of the findings to Tier III commercial banks in Kenya may be limited, as the study focused on manufacturing firms. Kimani (2020) studied the effect of the adoption of financial innovation on the performance of small and medium enterprises in Kenya. The study revealed that those SMEs that had adopted financial innovations experienced increased profits, market share, and decreased operational costs, hence improving their ultimate performance. However, this study by Kimani (2020) did not specify which sampling technique was used and had a different scope (SMEs) from the current study, whose main focus is tier III commercial banks; therefore, the findings may not be effectively generalized in Kenya. Zayyanu, Umar and Taiwo (2022) looked at the effect of payment system innovations on the financial performance of commercial banks in Nigeria. In their findings, Real Time Gross Settlement (RTGS) as a means of payment had a negative impact on the return of assets. However, this study was done in another country where different financial policies are used, and therefore, the findings may not hold true in the Kenyan context.

While these studies have cited evidence for the implementation of product innovation and its effect on financial performance in Kenya, there exists a knowledge gap that needs further research. Specific variables, such as product innovation practices, have not been fully analyzed and researched. Furthermore, the studies mentioned above present mixed findings, and therefore, there is a great need for additional evidence to support the product innovation practices and financial performance relationship to the tier III commercial banks in Kenya. By filling this gap, the study aims to contribute to a better understanding of how innovative product practices enhance financial performance, thereby providing valuable insights for banks' management and policymakers aiming to bolster financial stability and growth within this sector.

1.2. Research Hypothesis

- H_01: There is no statistically significant relationship between product innovation practices and the financial performance of Tier III commercial banks in Kenya.

2. Literature Review

2.1. Theoretical Foundation

2.1.1. Financial Intermediation Theory (FIT)

This theory was advanced by Gurley and Shaw in 1960. Financial intermediation theory explains the process in which financial institutions accept deposits from the surplus units of the economy and ultimately lend the same to the deficit units (Andries, 2019). It suggests that financial institutions, such as commercial banks, play a vital role in the economy by acting as intermediaries between savers and borrowers. They facilitate the flow of funds from surplus units (savers) to deficit units (borrowers) and provide various financial services to meet the needs of different stakeholders. When studying the influence of innovation practices on the financial performance of commercial banks, financial intermediation theory provides some insights. By embracing innovation practices, banks can improve operational efficiency, reduce costs, and broaden the customer base, enhancing their financial performance (Nyamori & Orwa, 2019).

Financial Intermediation Theory (FIT) states that innovation practices such as product innovation, payment channel innovation, and financial processes innovation enhance a bank's ability to attract deposits, lend efficiently, and generate revenue (Berger & Udell, 2020). By improving risk management capabilities, diversifying product offerings, and implementing efficient financial processes, Tier III banks strengthen their financial performance.

The relevance of this theory to the study is that by adapting innovation practices, tier III commercial banks are able to improve performance to enable them to perform the intermediary role well.

2.1.2. Technology Acceptance Model (TAM)

This model was advanced by Davis in 1986. The theory postulates that the acceptance of technology is predicted by the users' behavioral intention, which is, in turn, is determined by the perception of technology usefulness in performing the task and perceived ease of its use (Park, 2019).

The theory posits that employees' acceptance and utilization of new technologies in commercial banks are influenced by their perceptions of ease of use and usefulness, leading to enhanced job performance, operational efficiency, reduced costs, and improved financial performance (Davis, 2019). Similarly, customers' adoption of innovative banking services, like mobile banking apps and online payment platforms, is driven by their perceptions of these technologies' ease of use and usefulness (Davis, 2019).

The theory is vital to this study because it is used to explain how Tier III commercial banks adopt product innovative practices in their operations to improve their financial performance. By focusing on users' perceptions and attitudes towards new technologies and innovative practices, TAM helps identify potential barriers to adoption and informs strategies for promoting successful implementation and utilization within commercial banks.

2.2. Empirical Review

Adekunle (2021) studied product innovation practices and their impact on financial performance in Nigeria. The study utilized a quantitative research design, collecting data from a sample of manufacturing firms located across Nigeria. The study found a significant positive relationship between product innovation practices and financial performance in Nigerian manufacturing firms. The study concluded that product innovation practices play a crucial role in enhancing financial performance. However, the generalizability of the findings to Tier III commercial banks in Kenya may be limited, as the study focused on manufacturing firms.

Njagi (2016) conducted a study on the effect of product innovation on the profitability of private manufacturing firms in Nairobi County, and descriptive research was used. The study found a positive and significant correlation between product innovation and ROA. The findings also revealed a negative and significant correlation between the inflation rate and ROA. The study concluded that product innovation positively impacts profitability, but since it was conducted in the manufacturing sector, its findings may not directly apply to the banking sector. Therefore, a sector-specific study is needed to assess the influence of innovation practices on the financial performance of tier III commercial banks in Kenya.

Kamaika (2014) carried out a study on the effect of product innovation on the performance of commercial banks in Kenya. The study adopted a cross-sectional survey design approach, and its population comprised (43) forty-three commercial banks licensed by the Central Bank of Kenya as of 31st July 2014. A census sampling technique was used. The study concluded that product innovation impacts customer satisfaction and that the reputation in the market makes the bank stand out. However, the study by Kamaika (2014) focused on market share and customer satisfaction to measure organizational performance. The current study focuses on financial performance measured using ROA and ROE.

Product Innovation practices in the banking sector have become increasingly critical as financial institutions strive to meet changing customer demands, leverage technological advancements, and stay competitive (Smith, 2020). Tier III commercial banks in Kenya have adopted new product innovation practices that have influenced their financial performance. Product innovation practices refer to the methods and processes used by organizations to develop new or significantly improved products. Implementing effective product innovation practices enables companies to meet evolving customer needs, differentiate themselves in the market, and sustain long-term growth (Trott, 2018). According to Bigliardi (2013), these innovations contribute heavily to driving efficiency, fostering customer satisfaction, strengthening market positioning, streamlining operations, reducing costs, mitigating risks, and enhancing the bank's profitability, resulting in improved financial performance. Moreover, the innovation practices have played a vital role in enabling tier III commercial banks to respond swiftly to market changes and regulatory requirements, ensuring compliance and adaptability (Olawale et al., 2024). By continually offering new and improved products and services and implementing new channels and

technologies to facilitate financial transactions and payments, these banks have experienced enhanced customer satisfaction and loyalty (Bigliardi, 2013). This customer-centric approach not has only driven revenue growth to the organizations but has also fostered a positive reputation in the market.

3. Methodology

A descriptive research design was used in this study. It is a structure or plan for collecting and analyzing data to achieve the overall research objective. The target population of the study was 21 Tier III commercial banks licensed by the Central Bank of Kenya as of 1st February 2023. The researcher used the census technique to cover all 234 bank branch managers in Nairobi County.

The study used the following regression Model:

$Y = \beta 0 + B1X1 + +\varepsilon$

Where:

Y is the financial performance

β_0 = constant (coefficient of intercept)

X_1= Product innovation practices

ε =Error term

B_1 = regression coefficient of four variables.

4. Research Results

4.1. Descriptive Statistics

The respondents were asked to state the extent to which their banks have adopted innovation practices. This was done using a scale ranging from 1 to 5, where 5 = Very great extent, 4 = Great extent, 3=Moderate extent, 2 = Little extent, 1 = No extent. It was established that the majority of the respondents believed that product innovation practices have greatly been adopted in tier III banks, with 39.7% expressing this view. 36.6% of the respondents believed that product innovation practices had been adopted to a very great extent, while 23.7% stated that product innovation practices had been adopted to a moderate extent.

The first objective of the study was to examine the influence of product innovation practices on the financial performance of Tier III commercial Banks in Kenya. Standard deviations and the means were applied to present descriptive statistics. To achieve this objective, the respondents were asked to state their level of agreement with various statements on a five-point Likert scale where (5= strongly agree, 4=agree, 3=moderately agree, 2=disagree, 1=strongly disagree).

The findings presented in table 1 indicated that the majority of the respondents strongly agreed that the tier III commercial banks prioritize product innovation practices related to digital lending, such as developing user-friendly loan application interfaces and implementing automated approval processes, as evidenced by a mean rating of 4.41. Further, respondents agreed that the banks have collaborated with fintech partners and other institutions to enhance digital lending capabilities and explore opportunities in digital currencies (4.37). Moreover, the respondents agreed that tier III commercial banks have incorporated product innovation strategies concerning digital currencies, such as exploring the integration of blockchain technology for secure and efficient transactions, to enhance its competitive position in the market with a mean of 4.34 and that the banks introduce new digital lending products and features frequently to cater for evolving customer needs and preferences (3.34). In addition, the respondents noted that the banks allocate dedicated resources and budget for product innovation initiatives as supported by a mean of 4.34 and that there are specific metrics or key performance indicators (KPIs) in place to measure the success of product innovation efforts with a mean of 4.31. The respondents further agreed that there are established timelines or milestones for the development and launch of new products resulting from innovation efforts, and this was evidenced by a mean of 4.15.

Based on the study's results, the research shows that product innovation practices influence the financial performance of Tier III commercial Banks in Kenya. The findings reveal a robust infrastructure within commercial banks for product innovation, with dedicated teams and formal processes in place for idea evaluation and market research. The allocation of resources and establishment of metrics underscore a commitment to measuring and advancing innovation efforts, reflected in the establishment of clear timelines for product development and launch.

	N	Mean	Std. Deviation
The bank prioritizes product innovation practices related to digital lending, such as developing user-friendly loan application interfaces and implementing automated approval processes	224	4.41	.836
The bank has incorporated product innovation strategies concerning digital currencies, such as exploring the integration of blockchain technology for secure and efficient transactions, to enhance its competitive position in the market	224	4.34	.858
There are specific metrics or key performance indicators (KPIs) in place to measure the success of product innovation efforts	224	4.31	.984
The bank introduces new digital lending products and features frequently to cater for evolving customer needs and preferences	224	4.34	.746
The bank has collaborated with fintech partners and other institutions to enhance digital lending capabilities and explore opportunities in digital currencies	224	4.37	.670
There are established timelines or milestones for the development and launch of new products resulting from innovation efforts	224	4.15	.923
The bank allocates dedicated resources and budget for product innovation initiatives	224	4.34	.858
Valid N (listwise)	224		

Table 1: Influence of Product Innovation Practices on the Financial Performance of Tier III Commercial Banks in Kenya
Source: Research Data (2024)

4.2. Inferential Statistics

The study used a univariate regression analysis guided by the following null hypothesis:

- H_01: There is no statistically significant relationship between product innovation practices and the financial performance of Tier III commercial banks in Kenya

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.686[a]	.470	.468	.553
Predictors: (Constant), Product Innovations practices				

Table 2: Overall Fit Model Summary of Product Innovation Practices and Financial Performance
Dependent Variable: Financial Performance
Source: Research Data (2024)

The R-squared indicated in table 2 for the relationship between product innovation practices and financial performance among the Tier III commercial banks in Kenya was 0.470. This shows that product innovation practices explain 47.0% of the financial performance among the Tier III commercial banks in Kenya.

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	60.286	1	60.286	197.036	.000[b]
	Residual	67.924	222	.306		
	Total	128.210	223			
Dependent Variable: Financial Performance						
Predictors: (Constant), Product Innovations practices						

Table 3: ANOVA for Product Innovation Practices and Financial Performance
Source: Research Data (2024)

The overall ANOVA indicates that the F-calculated of the overall regression model was 197.036, which is greater than the F-critical, 2.413. In addition, the p-value, 0.000, was less than the significance level at 0.05. Thus, these findings show that the model was appropriate in predicting the influence of product innovation practices on the financial performance of tier III commercial banks in Kenya.

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.375	.203		6.783	.000
	Product Innovations practices	.678	.048	.686	14.037	.000
a. Dependent Variable: Financial Performance						

Table 4: Coefficients for Product Innovation Practices and Financial Performance
Source: Research Data (2024)

As shown in table 4, when the use of product innovation practices is held constant, the study's findings show that financial performance among the tier III commercial banks in Kenya will have an index of 1.375. Furthermore, the relationship between product innovation practices and financial performance among the tier III commercial banks in Kenya had an unstandardized beta coefficient (B) of 0.678. This means that increasing the adoption of product innovation practices by one unit will result in a 0.776 rise in financial performance among the tier III commercial banks in Kenya. The relationship is statistically significant at a P value of 0.000<0.05. In addition, the t-calculated, 14.037, was more than the t-critical, 2.132. The study rejected the first null hypothesis (H_01) and concluded that a significant relationship exists between product innovation practices and the financial performance of tier III commercial banks in Kenya. The findings of this study are consistent with those of Adekunle (2021), who concluded that there exists a significant relationship between product innovation practices and the financial performance of the firm sector. The findings further emphasize the potential benefits of investing in and prioritizing product innovation initiatives to sustainably improve the performance and competitiveness of tier III commercial banks in Kenya.

5. Conclusions and Recommendations

5.1. Conclusions

Based on the findings of this study, the study concludes that product innovation practices have a positive and significant effect on the financial performance of commercial banks in Kenya.

Further, it is evident that within Tier III commercial banks in Kenya, there is a robust infrastructure supporting product innovation, as indicated by the high mean ratings across various parameters. The presence of dedicated teams, formal evaluation processes, and allocation of resources underscore a commitment to fostering innovation. However, while there is encouragement for employee contribution, there seems to be room for improvement in this aspect, as reflected in the slightly lower mean rating. Nonetheless, the establishment of timelines and metrics for measuring success signifies a strategic approach to innovation management.

5.2. Recommendations

Based on the study's findings, it is recommended that commercial banks in Kenya prioritize investment in product innovation practices to drive improved financial performance. By actively fostering an environment conducive to innovation and encouraging cross-functional collaboration, banks can accelerate the development and implementation of innovative products tailored to meet the evolving needs of customers. Additionally, tier III commercial banks should leverage the insights gleaned from successful product innovation practices to inform their strategies and remain competitive in the market. Embracing innovation as a core principle is not only essential for the financial success of commercial banks but also crucial for sustaining relevance.

6. References

i. Africa Development Bank Group. (2021). *Africa Financial Markets Index 2020*. Retrieved from: https://www.afdb.org/en/knowledge/publications/africa-financial-markets-index
ii. Baker, H., Kaddumi, T. A., Nassar, M. D., & Muqattash, R. S. (2023). Impact of financial technology on improvement of banks' financial performance. *Journal of Risk and Financial Management, 16*(4), 230. https://doi.org/10.3390/jrfm16040230
iii. Berger, A. N., & DeYoung, R. (1997). Problem loans and cost efficiency in commercial banks. *Journal of Banking & Finance, 21*(6), 849–870.
iv. CBK. (2016). *Directory of licensed commercial banks, mortgage finance institutions, and authorized non-operating holding companies*. Central Bank of Kenya. Available at: https://www.centralbank.go.ke/wp-content/uploads/2023/01/Directory-of-Licenced-Commercial-Banks-Authorised-NOHCs-Jan-2023.pdf
v. Central Bank of Kenya. (2022). *Kenya financial sector stability report*. Retrieved from: https://www.centralbank.go.ke/wp-content/uploads/2021/05/Kenya-Financial-Sector-Stability-Report-2021.pdf
vi. Davis, E. P., & Yousef, T. (2012). Are banks really special? New evidence from the performance of financial institutions. *Journal of Financial Services Research, 42*(3), 195–216.
vii. Donkor, J., Donkor, G. N. A., Kankam-Kwarteng, C., & Aidoo, E. (2018). Innovative capability, strategic goals and financial performance of SMEs in Ghana. *Asia Pacific Journal of Innovation and Entrepreneurship, 12*(2), 238–254.
viii. Hertog, P. D., & Huizingh, E. K. (2019). Why firms innovate. *Journal of Innovation Management, 7*(2), 93–121.

ix. Kamakia, P. (2014). *Effect of product innovation on performance of commercial banks in Kenya* (Doctoral dissertation, University of Nairobi).
x. Kenya Bankers Association. (2022). *Banking industry performance*. Retrieved from: https://www.kba.co.ke
xi. Kimani, E. M. (2016). Effect of adoption of financial innovation on performance of small and medium enterprises in Kenya.
xii. Njagi, E. M. (2016). *The effect of product innovation on the profitability of private manufacturing firms in Nairobi County* (Doctoral dissertation, University of Nairobi).
xiii. Resa, J. M., Mithi, F., & Kosgei, M. (2022). Financial innovations and performance of tier III commercial banks in Kenya. *The Strategic Journal of Business & Change Management, 9*(2), 1083–1101.
xiv. Smith, A. (2020). Tier 3 banks are surging in 2020. Retrieved from: https://www.fool.com/investing/2020/08/10/tier-3-banks-are-surging-in-2020/
xv. Trott, P. (2018). *Innovation management and new product development* (4th ed.). Pearson Education.
xvi. Uford, I. C. (2018). Electronic banking application and Sterling Bank customers' adoption: Issues, challenges and benefits. *Business & Social Sciences Journal, 3*(2), 1–12.
xvii. Wambua, S. M., Namusonge, G. S., & Odhiambo, R. (2022). Financial innovation and financial performance of tier 3 commercial banks in Kenya. *American Journal of Humanities and Social Sciences Research, 6*(4), 48–55.