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The Effect of Product Differentiation Strategy on The Performance of Commercial Banks in Kenya.

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Abstract

Purpose: The study aimed to determine the effect of product differentiation strategy on the performance of commercial banks in Kenya. The study hypothesized that product differentiation had a statistically significant impact on Kenyan commercial banks' performance

Methodology: The study used a quantitative research method targeting the branch managers of licensed commercial banks in Nairobi County. A sample of 227 branch managers was selected using stratified sampling. Data was collected using an online questionnaire. Data was checked for internal consistency using Cronbach's alpha. The alpha was within the acceptable rate level of 0.60 to 0.90 The ordinal logistic regression was used to analyze the relationship between the variables.

Findings: The effect of product differentiation on performance was statistically significant (Wald = 7.768, df = 1, p = .005), with a 95% confidence interval of 0.442 to 2.535. Therefore, product differentiation statistically significantly affects commercial banks' performance. The results imply that banks need to increased focus on product differentiation strategies to increase performance.

Unique contribution to theory, practice and policy*:* The study is significant to bank managers because it provides them with information on one of the strategies (product differentiation) that managers can use to increase the performance of their banks. Implementing this strategy would result in increased performance and benefit the stakeholders due to the increased return on investment.

Keywords: *Commercial Banks, Product Differentiation, Performance*

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Introduction

Globally, entities are establishing strategies to increase their competitiveness in terms of growth, profitability, brand equity, and market share. Establishing a competitive strategy is crucial for businesses because it enables them to survive in highly competitive markets (Akande et al., 2019). Therefore, all organizations, including banks, face pressure to improve their competitive strategies continuously. The focus on competitiveness is attributed to the rise in complexity of the operating environment and the liberalization, which has resulted in the increased entry of new firms, thus increasing the competition (Balistreri et al., 2019). The primary reason why banks create and implement competitive strategies is to increase their performance.

The competitive strategy means how the business competes in its operation areas. Specifically, the competitive strategy defines how the organization aims to create and maintain a competitive advantage with respect to the competitors (Holdford, 2018). When establishing a competitive advantage, all the firms, including those operating in the financial sector, focus on distinct products and services sold to specific customers and the specific competitors to be faced (Bertelè & Chiesa, 2021).

Gaining a competitive advantage is associated with increased profitability in the long run. The superior competitive strategy is achieved in various ways, such as offering differentiated products from the competitors and lower-cost products (Erfani & Vasigh, 2019). Therefore, the competitive strategy in the banking sector is examined by assessing two factors; the creation of the competitive advantage and the protection of the competitive advantage (Dogru, 2019).

For this study, the competitive strategy that was assessed to determine the effect on financial performance is product differentiation. To enhance their performance as well as gain a competitive advantage in the market, commercial banks and other financial institutions have adopted product differentiation as a strategy to enhance their performance. In the financial market, product differentiation involves the creation of unique financial products and services that set a financial institution apart from its competitors. Because of personalizing offerings to meet specific and specific customer needs and preferences, financial institutions can attract more customers, increase customer loyalty, and ultimately improve the quality of their services (Wambaka, 2021). Product differentiation allows financial institutions to offer a wide variety of products and services that go beyond traditional banking. In addition to investment products, insurance, wealth management solutions, and tailored financing options, banks can also provide specialized investment services. Besides providing a source of additional revenue streams, diversification reduces the reliance on specific products and the risks associated with concentrated portfolios. The ability to understand the unique needs of various customer segments allows financial institutions to develop tailored

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products tailored to groups' needs. For instance, banks can customize the package to accommodate millennials, small businesses, or high-net-worth individuals. The degree of customization available to customers enhances customer satisfaction, fosters long-term relationships, and boosts customer retention, which ultimately contributes to an increase in financial performance. Those financial institutions that can differentiate their services and products from the rest develop an established brand identity that helps them establish trust and recognition among consumers, thereby positioning them as their preferred choice. A strong brand can attract new customers and strengthen the loyalty of existing ones, which positively impacts the financial institution's performance. Because of a highly competitive financial sector, product differentiation has been a key factor in distinguishing institutions from the competition. Offering exclusive products and services gives them an edge in the market, helps them acquire new customers, and helps them retain existing ones. Consequently, they can gain a competitive advantage, increase market share, expand their customer base, and contribute to their revenue growth (Kireru, Ombui, & Omwenga, 2020).

STATEMENT OF THE PROBLEM

In the East African region, Kenya boasts the highest number of commercial banks (Chipeta & Muthinja, 2019); therefore, there is high competition among the banking firms for individual and corporate clients. The high number of banks is attributed to favorable government regulations that have allowed the liberalization of the banking firms, making the sector competitive. The primary entry barriers are not regulations but the current minimum capital of Kshs. 1 billion. The availability of funds from private investment firms has enabled investors to raise the amount, thus starting many locally-owned banks (Yakubu et al., 2020). The few entry barriers have increased competition; thus, the banks must establish effective strategies to increase and retain competitiveness.

One of the motivations for carrying out this research is the increasingly competitive landscape of Kenya's commercial banks sector. According to CBK, 42 licensed commercial banks are striving to establish competitive strategies to gain market care and increase productivity. Another motivation is the adverse effects of the macroeconomic factors that affect the bank's performance. For example, the global output is estimated to decrease by 3.6% in 2023, and the slow growth in the advanced economies may lead to tighter financial regulations, adversely affecting the banks. Although the regional economy will increase, the rising inflation will likely erode consumer purchasing power, saving, and investment (CBK,2022). These issues are likely to affect the banks negatively; hence, it is critical to establish if their competitive strategies lead to increased performance.

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Another reason for the research is that despite the previous studies on the research topic, this study is unique in various ways. First, it used surveys of commercial banks, unlike the earlier studies that used a case of individual banks, thus improving the reliability of the findings. Second, instead of focusing on traditional variables such as customer satisfaction, mergers, and acquisition, it used s product differentiation, a dynamic and relatively new approach to competition. This focus widened the research gap on the competitive strategy used by commercial banks and addressed the research problem of product differentiation strategies used by commercial banks in the COVID-19 era impact the performance.

2.0 LITERATURE REVIEW

Porter's Generic Competitive Strategies Theory (1985)

The theory argues that there are two dimensions that the organization uses to increase competitive advantage; strategic strength and strategic scope (Njuguna, 2015). The strategic strength looks at the supply side of competencies: product differentiation and efficient cost. On the other hand, the strategic scope looks at the demand side, namely target market size and composition (Abdolshah et al., 2018).

Porter stressed two critical strategies that enhance the competitiveness of the firm; costs, product differentiation, and focus. The cost leadership strategy involves two steps; charging lower prices to attract more customers and increase the market share and increasing profits by reducing costs (Rothaermel, 2021). For the firms to be successful in the cost leadership strategy, they must have the resources to invest in technologies to reduce the costs, a low-cost base such as raw materials, labor, and very efficient logistics (Abdolshah et al., 2018).

On the other hand, the differentiation strategy involves making unique products; to attract new customers (Ali & Anwar, 2021). According to Ali and Anwar (2021), for the differentiation strategy to be effective, the firms must invest in research and development and innovation, effective sales, and marketing to increase consumer awareness of the product and deliver high-quality products and services. The focus strategy involves focusing on a particular niche based on various factors such as sociodemographics. The theory was relevant in this study because it explains how banks can use the product differentiation strategy to gain the competitive edge.

EMPIRICAL REVIEW

Various studies have been conducted to determine product differentiation strategies' effect on commercial bank performance. Kireru et al. (2020) researched the influence of competitive strategies on the organizational performance of commercial banks in Kenya using a case study approach. The study variables included innovation strategies, cost leadership, market focus strategies, and product differentiation. The study established that four variables had a positive impact on the performance of the bank. These findings are similar to findings in studies in other banks, such as Family Bank (Mwalili, 2020). The researcher sought to establish how product differentiation influences an organization's competitive advantage. The researcher assessed how differentiation strategies used by the bank increase the firms' competitiveness. The study concluded that the bank differentiates its products uniquely to meet the customer experience, which leads to a competitive advantage. Using Kenya Commercial Bank as a case study and product differentiation strategies as variables, Menga and Nyakwara (2020) concluded that product differentiation is positively associated with customer retention. The study did not evaluate the impact of product differentiation on performance; hence this study established the effect of product differentiation on performance. Other studies, such as Mramba (2013), have been conducted in Kenya; however, most of these studies did not specifically show the differentiation strategies used by the banks; hence they evaluated differentiation strategies used by the banks and their effect on performance.

Some studies have focused on the specific types of differentiation. For example, using service differentiation as a variable, Kibithe and Chebii (2019) surveyed 384 bank customers in Nakuru County. The researcher established that service quality differentiation enhances customer loyalty, a crucial nonfinancial performance measure. Product differentiation also led to increased performance, as established by a survey by Visedsun and Terdpaopong (2021) surveyed 1500 firms to determine the effect of product differentiation on performance. The researcher established that product differentiation enhanced the firm's performance.

Some researchers have used various types of performance when researching product differentiation and its impact on performance. The product differentiation process enables commercial banks to tailor their financial products and services to meet the needs and preferences of their target customers. A study by Gakuya and Njue (2018) concluded that banks implementing product differentiation strategies experience higher customer satisfaction. Another type of performance used to assess the commercial bank's performance is the marketing position. Banks differentiate themselves from competitors by developing a unique value proposition. Boehe and Cruz (2019) found that banks with strong product differentiation strategies achieved more market position and competitive advantage. Profitability and growth are also important to assess product differences and their impact on organizational performance. Specifically, in addition to increased margins, effective differentiation can lead to higher prices. According to a study by Albertazzi and Gambacorta (2019), banks that differentiate their products increase profits and revenue. Another study by Mugo et al. (2012) established that banks that differentiate their products tend to attract more customers and gain a competitive advantage, leading to higher profits and revenue. Among the factors influencing the performance of commercial banks in the digital era is the differentiation of their products. Das (2020) found that differentiation influences their performance significantly.

Although empirical studies have shown a positive relationship between differentiation strategies and a firm's performance, others, such as Acquaah and Agyapong (2015), have established no relationship between product differentiation and organizational performance. For example, Acquaah and Agyapong (2021) analyzed the data from 581 micro and small businesses (MSBs) in Ghana to determine the effect of competitive strategy on performance. The study concluded that cost leadership and differentiation improve the firm's performance. Similarly, using the product differentiation strategy as a variable, 248 samples were obtained from the manufacturing sector by Kharub et al. (2020), who established no relationship between the differentiation strategy and the performance of insurance firms in Kenya. The literature, therefore, shows that the relationship between the differentiation strategy and organizational performance is far from clear; thus, this study contributed to the establishment of a clear relationship between the two variables in the Kenyan context.

3.0 METHODOLOGY

The study used a cross-sectional design. The approach was suitable because it allowed data collection on the research variables without influencing the research subjects and enabled measuring the influence of the exposure variables (product differentiation) on the outcome variables (performance). The target population for the study was the branch managers of licensed commercial banks operating in Nairobi County. The targeting of the branch managers is appropriate because they have detailed information on the competitive strategies used in their respective branches. According to CBK (2022), 564 commercial bank branches operate in Nairobi County. The stratified random sampling was used to choose research participants. Random sampling enabled capturing the population that meets the desired characteristics and proportionally represents the population size. Assuming the response distribution of 50% (282), the following formula was used to calculate the sample size of the stratum Sample size for stratum = (Number of branches in stratum / Total number of branches) x Desired sample size. The primary data was collected using self-administered questionnaires; comprising closed-ended questions. Detailed questionnaire questions grouped according to the research objectives ensure content validity. Analysis of the content of the questions by the research supervisors and other experts determined assessed the content validity. Their inputs assisted in enhancing the content validity. The researcher required the participants to sign the consent form before filling out the online interviews. The research was also approved by the National Commission for Science, Technology, and Innovation

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(NACOSTI). The reliability statistics alpha was within the acceptable level of 0.60 to 0.90, indicating that the instrument was reliable (product differentiation 0.720) and performance (0.644)

4.0 RESULTS AND DISCUSSIONS

Pilot study

The pilot study was conducted in Muranga County using 20 commercial banks. The issues assessed during the pilot study include the capability of the subjects to comprehend the questions, instrument reliability, and research question sequence. The Cronbach alpha for the pilot items was 0.798, which indicated acceptable internal consistency.

Demographics

The research revealed that 78.4% of the respondents were male and 21.6% were female, indicating that the majority of the bank's branch managers in Nairobi are male such as Mutuma (2022), who established that males constitute 75.99% of the managerial staff and women 24.01%. Other researchers indicate that men hold the majority of managerial positions (Choge, 2015) and Kusuya (2021).

Another sociodemographic element assessed is the age of the respondents. The descriptive age, education level, and work experience are indicated in Figure 4.1. Most of the respondents were aged 42 to 52 years (43.9%), followed by above 52(42.4%), 31 to 41 years (12.9%), and 20 to 30 (0.7%). In terms of education level, most had postgraduate qualifications (54.7%), followed by undergraduate (42.4%) and diploma (2.9%). Another reason could be attributed to the professional credibility demonstrated by the postgraduates. In terms of working experience, most had 11 to 16 years (52.5%), followed by 5 to 10 years (36.0%), above 17 years (10.1%), and less than 5 years (1.4%). The working experience statistics indicate that branch managers have substantial working experience.

Descriptive statistics

Table 1: *Descriptive statistics on the product differentiation*

	N	Mean	Std. Deviation
The bank has more services than the major competitors.	139	3.23	1.175
The products are differentiated based on sociodemographic such as age, gender and income levels.	139	3.25	1.314

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The bank products are differentiated based on the operating region.	139	3.02	1.380
The bank has rebranded most of the products to achieve competitive advantage.	139	3.24	1.354
The bank activities are aligned with the product development process.	139	3.15	1.424
The bank promotes product credibility and transparency.	139	3.27	1.266
The product quality, and reliability is better than the competitors.	139	2.93	1.317
The pricing model for the products is unique.	139	2.87	1.290
The customer interactions initiatives are different from the competitors.	139	3.22	1.498
Products are customized according to the customer requirements.	139	2.94	1.312

The table indicates that most respondents had a neutral view of most product differentiation statements. Expressly, they indicated neutral views on their banks having more services than the competitors, differentiation of products based on the sociodemographic, differentiation based on the operating region, rebranding to achieve a competitive advantage, product credibility and transparency, and different customer interaction initiatives than the competitors. The neutral view on these items means there is no strong inclination towards either agreement or disagreement. It could also mean that based on the assessed element, the respondents view that the banks have no competitive edge. The participants disagreed that their banks have better product quality and reliability than competitors, unique pricing models, and customization of products according to the customer's requirements. As indicated by Kireru et al. (2020), the disagreement in the various statements could be attributed to the feeling that the managers perceive the differentiation strategies taken by the banks are inadequate to enhance competitive advantage.

Regression

The non-parametric tests are suitable for assessing the independent and dependent variables. The regression model was used because the study aimed to establish the relationship between the variables. However, the most common regression method (linear regression) was not used because Likert scale data is ordinal; scale categories have a logical order but do not have equal intervals, hence violating the assumption of linear regression of continuous data, with equal intervals between the values (Schroeder et al., 2019). Also, when the data is treated as continuous by adding the Likert scale values and obtaining the average, the transformation treats each category as a numerical value, which disregards the ordinal nature of the scale, leading to misinterpretation and incorrect conclusions about the relationship between variables (Liu, 2016). Therefore, due to these limitations, ordinal logistic regression was used to establish the relationship between the ordinal variables.

Table 2 indicates the ordinal regression model fit. The p-value associated with the Chi-Square test is 0.000, which indicates that the final model significantly improves the fit compared to the intercept-only model. In table, 3, the good-of-fit is indicated. The good of fit indicates how well the model fits the data. The ordinal regression analysis revealed that the final model, which included predictor variables, provided a significantly better fit to the data compared to the intercept-only model ($\chi^2 = 48.586$, $df = 4$, $p < .001$). The goodness-of-fit tests indicated that both the Pearson ($\chi^2 = 15.207$, $df = 10$, $p = .125$) and Deviance ($\chi^2 = 16.377$, $df = 10$, $p = .089$) Chi-Square statistics did not show significant deviations from the expected frequencies.

Table 2: *Model fitting information*

Model	-2 Log Likelihood	Chi-Square	df	Sig.
Intercept Only	90.572			
Final	41.986	48.586	4	.000

Link function: Logit.

Table 3: *Goodness-of-fit*

	Chi-Square	Df	Sig.
Pearson	15.207	10	.125
Deviance	16.377	10	.089

Link function: Logit.

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Table 4 shows the pseudo R-square. "The ordinal regression model demonstrated a moderate fit to the data, as indicated by the Cox and Snell Pseudo R-Square of .295, the Nagelkerke Pseudo R-Square of .418, and the McFadden Pseudo R-Square of .285. The model utilized the logit link function to relate the linear regression model to the observed probabilities.

Table 4 : *Pseudo R-Square*

Cox and Snell	.295
Nagelkerke	.418
McFadden	.285

Link function: Logit.

The threshold parameter is shown in table 5 The threshold parameter estimates indicate the effect of the predictor variable (performance)on the odds of achieving higher levels of the outcome variables. The estimate of 5.524 suggests that for each unit increase in the performance, the odds of moving to a higher level of the outcome variable increase by a factor of exponential of 5.524 or approximately 250 times. This effect is statistically significant (Wald = 23.758, *df* = 1, *p* < .001), as the confidence interval (3.303 to 7.746) does not include zero.

							95% Confidence Interval	
		Estimate	Std. Error	Wald	Df	Sig.	Lower Bound	Upper Bound
Threshold	[Performance]	5.524	1.133	23.758	1	.000	3.303	7.746
Location	Product differentiation	1.488	.534	7.768	1	.005	.442	2.535
	COVID-19 recovery	1.248	.540	5.335	1	.021	.189	2.307
	Human capital	.760	.489	2.422	1	.120	-.197	1.718

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Innovation	.447	.546	.670	1	.413	-.623	1.517

Link function: Logit.

The estimate of 1.488 suggests that for each unit increase in this predictor variable, the odds of moving to a higher level of the outcome variable increase by a factor of exp(1.488) or approximately 4.42 times. This effect is statistically significant (Wald = 7.768, df = 1, p = .005), with a 95% confidence interval of 0.442 to 2.535. Therefore, product differentiation statistically significantly affects the commercial bank's performance. The findings are similar to Kireru et al. (2020) that firms implementing the product differentiation strategy will likely perform better. Also, the findings are similar to Mwalili's (2020) study, that established that the banks differentiate their products uniquely to meet the customer experience, which leads to competitive advantage. Overall, this result supports the numerous studies (Menga & Nyakwara, 2020; Mramba,2013; Kibithe and Chebii 2019) that indicate that product differentiation leads to increased performance.

4.0 CONCLUSION

The study investigated the effect of product differentiation on the performance of commercial banks in Kenya operating in Nairobi County, Kenya. The study was guided by Porter's Generic Competitive Strategies Theory (1985). The results reveal that product differentiation significantly impacted the Kenyan commercial bank's performance. The findings support the most information from the literature, indicating that the firms that focus on the differentiation strategy have better performance than those that do not. The study implies that commercial banks should use product differentiation as a strategy to enhance competitiveness.

Recommendations for Practice

It is also recommended that the banks continuously review product differentiation strategies to ensure that they comply with the market and employee expectations. The bank should also focus on product differentiation as the performance driver. This can be achieved through various strategies such as encouraging innovation and experimentation among the employees, customization of the products to meet the customer needs, and identifying unique selling points.

Recommendations for Research Findings

The research recommends further research using qualitative research. The qualitative research would enable exploring the implementation of the competitive strategies used by the commercial banks and how they contribute to the performance of the banks. Specifically, through in-depth interviews, it would be possible to assess the views of the managers and bank employees on the various aspects of implementing competitive strategies and performance.

Considering that the study was conducted in Nairobi county, it is important to conduct a comparative analysis across different regions in Kenya to allow a broader understanding of competitive strategies and the effect of performance across different regions. For example, compare banks in Major cities such as Nairobi and Mombasa or the banks operating in the rural areas and those of the rural areas, rural areas, and resource-deprived regions. Also, the longitudinal study can be conducted to investigate the long-term effect of competitive strategies on performance.

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