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Should Banks Diversify or Focus?

Executive Summary

In the last twenty years, the banking sector (globally) has remarkably changed, with a majority of players now keen to pursue functional diversification across activities such as lending, investment banking, real estate, insurance among others. This development has raised a thriving debate on whether functionally diversified banks have a comparative advantage over their specialized ones. Arguments for and against functional diversification exist, with studies offering mixed results. This brief provides insights on the debate based on a study conducted to ascertain the influence of diversification on bank performance in Kenya especially during the economic crisis brought about by the ongoing COVID-19 pandemic. Importantly, a study of the Kenyan commercial banks over the period 2010-2020 reveals that banks which diversify their sources of revenues tend to be more profitable and financially stable. In addition, reliance on non-interest revenue sources acts as an economically important shock absorber in times of declining profits such as witnessed in the ongoing COVID-19 pandemic. From a policy perspective, these results encourage banks to leverage on emerging opportunities to create new products, particularly those whose operating marginal costs are small. This also calls for regulators to remain open to such innovations since they confer stability benefits.

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1. Context and Importance

The role of revenue diversification on bank performance and stability has been an intriguing theme of discussion among policy makers for the last 20 years or so. In a nutshell, the debate can be summarized as follows: revenue diversification reduces diversifiable (unsystematic) risk ("Do not put all your eggs in one basket") whereas focus strategies reduce agency problems (associated with many operational activities) and increase the utilization of expertise and other acquired abilities ("Put all your eggs in one basket and closely watch them").

More specifically, the proponents of diversification cite several potential advantages that may accrue to users. First, diversification lowers operating costs through the sharing of inputs such as labour, technology, and information across many business lines. For example, information gathered from the lending business can be used to efficiently provide other financial products such as insurance and security underwriting. Further, the information obtained through investment banking can be used to improve loan origination and credit risk management. Second, functional diversification has potential to foster corporate governance through the takeover market. That is, if cross-activity mergers are allowed, then a manager will have incentives to operate efficiently to avoid being merged or acquired by a well performing unit. Third, diversification is beneficial from a risk perspective as the different lines of business of a functionally diversified bank may be lowly correlated.

In contrast, the opponents of bank income diversification argue that diversification has costs. First, it potentially exacerbates agency problems between insiders and outsiders, between business divisions, and between the business units and their customers (through conflicts of interest). For example, a bank manager may pursue diversification to further personal interests even when diversification would reduce the franchise value of the bank. Second, diversification results in multiple business lines which may increase the regulatory costs associated to multiple supervision. Third, since regulators do not require banks to hold capital against fee-intensive products, banks may be incentivized to engage in excessive financial leverage, a situation that is likely to increase earnings' volatility and increase the likelihood of a systemic crisis.

Thus, it is unclear whether the benefits of functional diversification outweigh the costs. Interestingly, empirical studies also appear inconclusive. For instance, several studies support the risk-reducing diversification hypothesis, while several others conclude that by diversifying, banks venture into uncharted waters losing out in the end.

This study revisits this debate by considering data from the Kenyan banking industry. Interestingly, in recent years, especially, after 2016, a typical Kenyan bank has been deriving more revenue from non-interest income than from interest income (See **Figure 1**). The decline of interest income can plausibly be associated with the introduction of interest rate controls implemented

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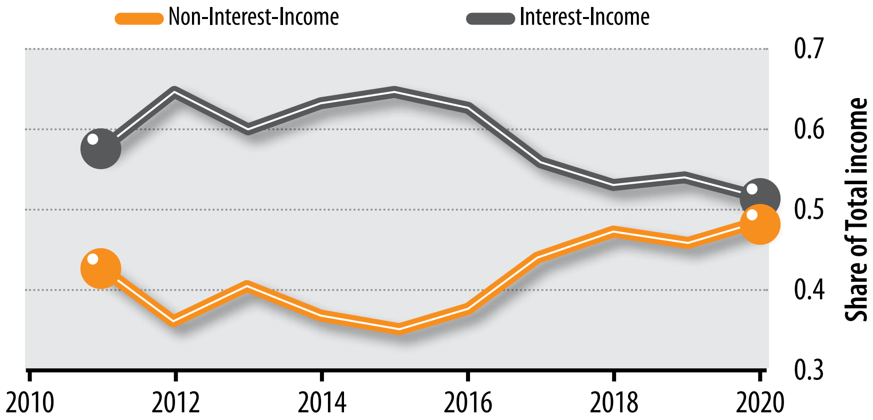
Figure 1: Trend of Interest/non-interest income (2010 - 2020)



> **Diversification (which is represented by a bank's share of non-interest income in the total operating income) bears a significant positive effect on returns to assets and returns on equity**

between September 2016 and November 2019. Additionally, the study examines the relation between diversification, profitability, and stability particularly highlighting the COVID-19 pandemic period. The ongoing pandemic has dampened economic activity in Kenya. It is therefore important to examine whether functionally diversified banks have had any comparative advantage over their specialized peers.

2. Data, Methods, and Results

The study underlying this policy brief employs annual bank data for the period 2010 to 2020; and an analytical technique that brings out dynamics across time and each bank to the interaction between diversification, profitability, and stability. Diversification was measured by the share of non-interest income in total operating income of a given bank. Profitability was measured by the return on assets and return on equity. Bank financial stability was captured by two measures: standard deviation (volatility) of profitability and the distance to default of a given bank (also popularly known as Z-Score). The study also controls for several bank characteristics.

The study findings reveal that more diversified banks have a comparative advantage over their focused (less diversified) peers. More specifically, diversification (which is represented by a bank's share of non-interest income in the total operating income) bears a significant positive effect on returns to assets and returns on equity. This effect is significant over the entire sample period but more importantly during the COVID-19 crisis period. This result is thus consistent with the hypothesis that diversification cushioned banks from the economic crisis occasioned by the COVID-19 pandemic. Further, the analysis reveal that diversification bears a negative relationship with standard deviation of bank returns and a positive relationship with distance-to-default measure. Overall, this result appears consistent with the hypothesis that diversification enhances stability of Kenyan banks. The effect is, however, weak during the COVID-19 crisis implying that diversification was not quite beneficial from a stability perspective during the ongoing pandemic crisis.

3. Conclusions and Policy Implications

The results of this paper have one key policy implication. Since this study shows that revenue diversification results in higher and stable profits, banks should be encouraged to leverage on new technologies to create non-traditional products whose operating marginal costs are small. This also calls for bank supervisors to provide a regulatory environment that supports innovative products.

Reference

Ochenge R., 2022. *The effect of revenue diversification on bank profitability and stability during the COVID -19 Pandemic: Evidence from Kenya. KBA Working Paper Series (WPS/05/2022)*

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