**INVESTMENT BANKING DIVERSIFICATION: A STUDY OF THE MOTIVATIONS AND CHALLENGES OF EXPANDING INTO NEW PRODUCTS AND MARKETS.**

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**ABSTRACT**

*This study examines the drivers and barriers of investment banking diversification, which refers to the expansion of investment banks into new products and markets. The study adopts a literature review approach, synthesizing the existing theoretical and empirical evidence on the topic. The study identifies four main drivers of diversification: client demand, competitive advantage, regulatory pressure, and innovation opportunities. The study also reveals four main barriers of diversification: operational complexity, cultural resistance, reputational risk, and market uncertainty. The main findings are that investment banking diversification is motivated by several factors, such as revenue growth, risk reduction, cross-selling opportunities, economies of scale and scope, and regulatory arbitrage. However, investment banking diversification also faces several challenges, such as organizational complexity, cultural clashes, agency problems, diseconomies of diversification, and regulatory scrutiny. The study contributes to the literature on investment banking strategy by providing an in-depth understanding of the motivations and challenges of diversifying in a dynamic and competitive environment. The study concludes that investment banking diversification is a double-edged sword that requires careful strategic management and alignment with the bank's core competencies and competitive advantages. The study also offers practical implications for investment bankers and regulators on how to manage the trade-offs between diversification and specialization*.

**INTRODUCTION**

Investment banking is a highly competitive and dynamic sector that offers a range of financial services to clients, such as underwriting, mergers and acquisitions, trading, and advisory. However, in recent years, investment banks have faced various challenges, such as increased regulation, market volatility, technological disruption, and changing customer preferences (Urbaniec, & Żur, 2021). These challenges have prompted some investment banks to diversify their business models by expanding into new products and markets, such as wealth management, private equity, Fintech, and emerging economies. The aim of this study is to explore the drivers and barriers of investment banking diversification, and to understand the motivations and challenges of investment banks that pursue this strategy. The study will adopt a literature review approach, which involves collecting, analyzing, and synthesizing existing academic and industry sources on the topic.

**LITERATURE REVIEW**

Investment banking is a highly competitive and dynamic industry that offers a range of financial services to clients, such as underwriting, mergers and acquisitions, trading, and advisory. In recent years, investment banks have faced various challenges, such as increased regulation, market volatility, technological disruption, and changing customer preferences (Tran, et al., 2020). These challenges have prompted some investment banks to pursue diversification strategies, which involve expanding into new products and markets to reduce risk and enhance profitability. Diversification is a strategy that aims to reduce the risk and volatility of a portfolio by investing in a variety of assets that have low or negative correlation with each other (McInerney, & Bunn, 2019). Diversification can be achieved at different levels of investment banking, such as product, market, client, and geographic diversification.

1. Product diversification refers to offering a range of products and services that cater to different segments of the market and meet the varying needs and preferences of clients. Product diversification can help investment banks to increase their revenue streams, enhance their competitive advantage, and hedge against market fluctuations (Bollaert et al., 2021). However, product diversification also entails higher costs of research and development, marketing, and regulation, as well as potential conflicts of interest and reputation risks.
2. Market diversification refers to expanding into new markets or regions that have different characteristics and opportunities than the existing ones. Market diversification can help investment banks to access new sources of growth, diversify their client base, and reduce their exposure to regional shocks (Baycan Levent et al., 2003). However, market diversification also involves higher risks of political, legal, cultural, and operational uncertainties, as well as increased competition from local players
3. Client diversification refers to serving a broad spectrum of clients across different sectors, industries, and sizes. Client diversification can help investment banks to reduce their dependence on a few large clients, increase their cross-selling potential, and leverage their network effects (DeYoung et al., 2009). However, client diversification also requires more resources and capabilities to understand and satisfy the diverse needs and expectations of clients, as well as to manage the complexity and coordination of multiple relationships.
4. Geographic diversification refers to operating in multiple countries or regions that have different economic and financial conditions. Geographic diversification can help investment banks to exploit the differences in interest rates, exchange rates, tax regimes, and regulatory frameworks across markets, as well as to benefit from the global integration of capital flows. However, geographic diversification also poses higher challenges of managing the currency risk, compliance risk, cultural differences, and coordination costs across different locations.

Diversification can take various forms, such as horizontal diversification (offering new products or services within the same segment), vertical diversification (moving up or down the value chain within the same segment), or diagonal diversification (entering new segments or industries). Diversification can also be achieved through organic growth (developing new capabilities internally) or inorganic growth (acquiring or partnering with other firms externally).

**DRIVERS OF DIVERSIFICATION IN INVESTMENT BANKING**

1. Globalization: The increasing integration and interdependence of the global economy and financial markets have created opportunities and challenges for investment banks. On one hand, globalization has enabled investment banks to access new markets, clients, and sources of capital, as well as to leverage economies of scale and scope. On the other hand, globalization has also increased the complexity and volatility of the business environment, as well as the competition and regulatory pressure from both domestic and foreign players.
2. Digitalization: The rapid advancement and adoption of digital technologies have transformed the way investment banks operate and interact with their stakeholders. Digitalization has enabled investment banks to improve their efficiency, agility, innovation, and customer experience, as well as to reduce their costs and risks. Digitalization has also created new opportunities and threats for investment banks, such as new products and services (e.g., robo-advisory, blockchain-based solutions), new channels and platforms (e.g., online trading, social media), new competitors and disruptors (e.g., fintechs, big techs), and new regulations and standards (e.g., data privacy, cyber-security).
3. Regulation: The financial crisis of 2008-2009 and its aftermath have led to a wave of regulatory reforms and interventions in the financial sector, especially in the investment banking industry. These reforms have aimed to enhance the stability, transparency, accountability, and resilience of the industry, as well as to protect the interests of investors, consumers, and society at large. However, these reforms have also imposed significant costs and constraints on investment banks, such as higher capital and liquidity requirements, stricter compliance and reporting obligations, lower leverage and profitability ratios, and more stringent supervision and enforcement actions.
4. Technological innovation: The rapid development and adoption of new technologies, such as artificial intelligence, blockchain, cloud computing, and big data analytics, have transformed the landscape and operations of investment banking. These technologies have enabled new entrants, such as Fintech startups and platform companies, to challenge the traditional incumbents by offering more efficient, convenient, and personalized services to customers. They have also created new opportunities for investment banks to enhance their capabilities, efficiency, and differentiation by leveraging these technologies in areas such as risk management, product development, customer relationship management, and compliance.
5. Customer preferences: The changing needs and expectations of customers have also influenced the diversification strategy of investment banks. Customers are increasingly demanding more customized, holistic, and value-added solutions that can address their complex and diverse financial goals. They are also more aware and concerned about the environmental, social, and governance (ESG) impacts of their investments. Therefore, investment banks have to adapt their offerings and approaches to cater to these preferences by providing more tailored, integrated, and sustainable solutions across different asset classes and regions.

**THE BENEFITS/MOTIVATIONS OF DIVERSIFICATION IN INVESTMENT BANKING**

Diversification in investment banking is a strategy that aims to reduce the exposure to market risks and enhance the returns by investing in different types of assets and markets. Diversification can be achieved by allocating funds across different asset classes, such as stocks, bonds, commodities, real estate, and cash, as well as across different countries, industries, sizes of companies, or term lengths for income-generating investments (Gopal et al., 2021). Diversification is based on the idea that not all assets or markets move in the same direction or at the same magnitude at any given time, so by holding a diversified portfolio, investors can benefit from the positive performance of some investments while offsetting the negative performance of others. Diversification can also help investors cope with unexpected events or changes in the market conditions that may affect their investments.

1. Revenue stability: Diversification can help investment banks to smooth out their revenue streams and reduce their dependence on a single source of income. For example, if the underwriting business is weak due to low demand for new securities issuances, the investment bank can rely on other businesses such as trading or advisory to generate revenue. Diversification can also help investment banks to exploit cross-selling opportunities and offer a wider range of services to their clients.
2. Risk reduction: Diversification can help investment banks to lower their exposure to any single asset or risk factor. For example, if the stock market crashes, the investment bank can mitigate its losses by holding other assets such as bonds or commodities that are less correlated with stocks (Oladimeji & Udosen, 2019). Diversification can also help investment banks to hedge against various types of risks, such as market risk, credit risk, operational risk, or liquidity risk.
3. Competitive advantage: Diversification can help investment banks to gain a competitive edge over their rivals by offering more value-added services and solutions to their clients. For example, an investment bank that can provide both underwriting and advisory services can have an advantage over an investment bank that only specializes in one service (Cueto et al., 2022). Diversification can also help investment banks to attract and retain talent by offering more career opportunities and incentives.
4. Improve the risk-return profile: By holding a variety of investments that have different expected risks and returns, and that are not perfectly correlated with each other, an investment bank can reduce the overall volatility of its portfolio and increase its expected return for a given level of risk. Diversification can also help investment banks avoid losses from extreme events or market downturns that affect a specific asset class or market.
5. Lower the costs of investing and financing: By diversifying their sources of funding, investment banks can reduce their dependence on any single lender or market and access cheaper and more stable capital (Luo & Tung, 2007). By diversifying their revenue streams, investment banks can reduce their reliance on any single product or service and increase their profitability and competitiveness.
6. Increase the resilience and sustainability: By diversifying their activities across different sectors and regions, investment banks can reduce their exposure to cyclical or structural changes in a specific industry or economy and benefit from growth opportunities in emerging or niche markets. Diversification can also help investment banks cope with regulatory changes, technological disruptions, or environmental challenges that affect different markets differently.

**THE RISKS/CHALLENGES/COST OF DIVERSIFICATION IN INVESTMENT BANKING**

A diversified portfolio contains a mix of distinct asset types and investment vehicles in an attempt at limiting exposure to any single asset or risk. Investment banking is a highly competitive and profitable industry, but also faces significant risks from market fluctuations, regulatory changes, reputational damage, and operational failures.

1. Increased complexity and coordination costs: Diversifying across multiple businesses and geographies can increase the complexity and cost of managing and coordinating the operations of an investment bank. It can also create conflicts of interest and agency problems among different units and stakeholders.
2. Reduced focus and expertise: Diversifying too broadly or too quickly can dilute the focus and expertise of an investment bank in its core competencies and competitive advantages. It can also make it harder to monitor and control the quality and performance of its diversified activities.
3. Regulatory constraints and compliance risks: Diversifying across different jurisdictions and regulatory regimes can expose an investment bank to different rules and standards that may limit its flexibility and efficiency. It can also increase the risk of violating or being penalized by regulators for non-compliance or misconduct.

In the context of investment banking, diversification can take different forms, such as expanding into different business lines, geographic regions, or client segments. The main benefit of diversification is that it can lower the exposure to idiosyncratic shocks and increase the stability of earnings and returns. However, diversification also entails costs and trade-offs that may outweigh its benefits in some cases.

One of the costs of diversification is the loss of focus and specialization. By engaging in multiple activities, investment banks may dilute their core competencies and lose their competitive edge in their original markets (Stiroh, 2010). Moreover, diversification may increase the complexity and opacity of investment banks, making them harder to monitor and regulate. This may lead to higher agency costs, information asymmetries, and moral hazard problems. Another cost of diversification is the potential increase in systemic risk. Although diversification may reduce the bankruptcy chances for an individual bank, it may also create more linkages and interdependencies among banks and other financial institutions (Urbaniec & Żur, 2021). This may make the financial system more vulnerable to contagion and spillover effects in times of stress. For example, during the global financial crisis of 2007-2009, many diversified investment banks suffered from liquidity shortages and solvency problems due to their exposure to subprime mortgages and other toxic assets. The optimal level of diversification for investment banks depends on a careful balance between the benefits and costs of diversification (Nguyen et al., 2020). The optimal level may vary depending on the characteristics of the bank, such as its size, scope, governance structure, risk appetite, and market position. Moreover, the optimal level may change over time as the market conditions and regulatory environment evolve.

**FACTORS THAT INFLUENCE THE DECISION TO DIVERSIFY IN INVESTMENT BANKING**

The decision to diversify in investment banking is influenced by various factors, such as market conditions, regulatory environment, competitive pressures, and firm-specific characteristics.

1. The degree of uncertainty: Uncertainty can arise from macroeconomic shocks, regulatory changes, technological innovations, or competitive pressures. Uncertainty can have both positive and negative effects on diversification. On the one hand, uncertainty can increase the value of diversification by providing opportunities to exploit synergies, economies of scale, or market power across different segments (Cueto et al. 2022). On the other hand, uncertainty can also increase the costs of diversification by making it harder to coordinate and monitor diverse activities, or by exposing the firm to more sources of risk.
2. Cost of capital: Diversification can affect the capital structure and financing choices of investment banking firms. For example, diversification can reduce the volatility of cash flows and earnings, which can lower the cost of debt and increase the debt capacity of the firm (Baycan Levent, et al., 2003). Alternatively, diversification can also increase the information asymmetry and agency problems between managers and investors, which can raise the cost of equity and reduce the equity value of the firm. Therefore, the optimal level of diversification depends on how diversification affects the trade-off between debt and equity financing.
3. Competitive advantage & Firm’s core competencies: Diversification can be a way to leverage existing skills and resources across different markets or products, or to acquire new capabilities that enhance the firm's performance (Nguyen et al., 2020). However, diversification can also dilute or erode the firm's competitive advantage if it diverts attention and resources away from its core activities, or if it creates conflicts or inconsistencies with its existing strategy. Therefore, the decision to diversify should be aligned with the firm's strategic goals and vision.

**FUTURE TRENDS AND IMPLICATIONS OF DIVERSIFICATION IN INVESTMENT BANKING**

1. Increasing focus on advisory services: Advisory services, such as mergers and acquisitions (M&A), capital raising, restructuring, and strategic consulting, are expected to grow in demand and importance in the post-pandemic era. This is because many companies will seek to reshape their strategies, portfolios, and capital structures to cope with the changing market conditions and opportunities. Advisory services are also less capital-intensive and more resilient to regulatory changes than other businesses. Therefore, investment banks will likely invest more resources and talent in developing their advisory capabilities and expanding their coverage across different sectors and regions.
2. Growing presence in emerging markets: Emerging markets, such as China, India, Brazil, and Southeast Asia, offer significant growth potential for investment banking due to their large populations, rising incomes, urbanization, digitalization, and infrastructure development. These markets also present unique challenges and opportunities for investment banks in terms of regulatory frameworks, cultural differences, and competitive landscapes. Therefore, investment banks will likely seek to diversify their presence and offerings in these markets by forming strategic partnerships, acquiring local players, or establishing joint ventures with local institutions.
3. Diversifying into alternative asset classes: Alternative asset classes, such as private equity, hedge funds, real estate, infrastructure, and commodities, are expected to attract more interest and capital from investors due to their higher returns, lower correlations, and diversification benefits (Geddes et al., 2020). Investment banks can leverage their expertise, networks, and platforms to offer access and solutions to these alternative asset classes to their clients. They can also diversify their own portfolios by investing in these asset classes to generate additional income and hedge against market risks.
4. Integrating ESG factors into products and services: ESG factors are becoming more relevant and influential in the investment decisions of both institutional and individual investors. Investors are increasingly looking for products and services that can align their financial objectives with their ESG values and goals. Investment banks can respond to this trend by integrating ESG factors into their products and services, such as offering ESG-themed funds, indices, and bonds, providing ESG advisory and rating services, and incorporating ESG criteria into their risk management and reporting processes.

**DIVERSIFICATION AND PERFORMANCE**

The main rationale for investment banking diversification is to exploit economies of scope, reduce income volatility, and enhance bank value. However, the relationship between investment banking diversification and performance is not clear-cut. Some studies have found positive effects of diversification on bank performance, while others have reported negative or mixed results (Bell, et al., 2012). The performance effects of diversification may depend on various factors, such as the type and degree of diversification, the quality of human capital, the ownership structure, and the regulatory environment (Oladimeji, & Udosen, 2019). For example, Adesina (2021) examined how human capital efficiency moderates the impact of diversification on bank performance in 34 African countries. He found that higher diversification reduces bank performance while higher levels of human capital efficiency are positively associated with bank performance. He also found that the performance-reducing effects of diversification decrease as bank human capital efficiency improves. Similarly, Alouane et al. (2022) investigated the effects of income diversification on bank performance and how ownership structure affects this relationship in Tunisian banks. They found that increased diversification improves bank performance, but the benefits of diversification are offset by the increased exposure to volatile noninterest income. They also observed that banks with concentrated ownership moderate the impact of diversification on performance in Tunisian banks. On the other hand, Chen et al. (2019) analyzed the relationship between asset diversification and bank performance in three Asian countries: China, Japan, and Korea. They found that asset diversification has no significant and positive effect on bank performance in these countries. They argued that asset diversification may not generate sufficient benefits to outweigh the costs of increased complexity and risk.

**CONCLUSION**

This study aimed to explore the drivers and barriers of investment banking diversification, which refers to the strategy of expanding into new products and markets to reduce risk and increase profitability. Based on a literature review of relevant academic and industry sources, the study identified several factors that influence the diversification decisions of investment banks.

The main drivers of diversification include:

1. The need to adapt to changing market conditions and customer demands
2. The desire to exploit synergies and economies of scale and scope
3. The opportunity to access new sources of revenue and growth
4. The potential to enhance competitive advantage and reputation

The main barriers of diversification include:

1. The complexity and cost of managing diverse businesses and operations
2. The risk of diluting core competencies and brand identity
3. The challenge of complying with different regulatory frameworks and standards
4. The difficulty of balancing stakeholder interests and expectations

The study concluded that investment banking diversification is a dynamic and multifaceted phenomenon that requires careful analysis and evaluation of the benefits and costs involved.

**POLICY RECOMMENDATIONS**

Based on the literature review of the drivers and barriers of investment banking diversification, this paper offers the following policy recommendations for investment banks that seek to expand into new products and markets:

1. Invest in human capital development: The literature suggests that human capital is a key driver of diversification, as it enables investment banks to leverage their existing expertise and networks to enter new domains. Therefore, investment banks should invest in training, mentoring, and retaining their talent, as well as attracting new talent with diverse skills and backgrounds.
2. Adopt a flexible and adaptive organizational structure: The literature indicates that organizational structure can either facilitate or hinder diversification, depending on the degree of autonomy, coordination, and integration among different units. Therefore, investment banks should adopt a flexible and adaptive organizational structure that allows them to balance the trade-offs between efficiency and innovation, as well as to respond quickly to changing market conditions and customer needs.
3. Manage the risks and costs of diversification: The literature highlights that diversification entails significant risks and costs, such as regulatory compliance, operational complexity, and reputational damage. Therefore, investment banks should manage the risks and costs of diversification by conducting rigorous due diligence, establishing clear governance and accountability mechanisms, and communicating effectively with their stakeholders.

**SUGGESTIONS FOR FURTHER STUDY**

1. This study has explored the drivers and barriers of investment banking diversification, a strategy that involves expanding into new products and markets to reduce risk and increase profitability. Based on a literature review of academic and industry sources, the study has identified several factors that motivate and challenge investment banks to pursue diversification, such as competitive pressure, regulatory changes, technological innovation, client demand, organizational culture, operational complexity, and reputational risk. However, this study has some limitations that suggest directions for further research.
2. The literature review was mainly based on secondary data from publicly available sources, which may not capture the full range of perspectives and experiences of investment bankers and other stakeholders. Future research could benefit from conducting primary data collection through interviews, surveys, or case studies to gain more insights into the decision-making process and outcomes of diversification strategies.
3. The literature review focused on the global investment banking industry as a whole, without differentiating between different types of investment banks (such as bulge bracket, boutique, or regional) or different geographic regions (such as North America, Europe, or Asia). Future research could examine how diversification drivers and barriers vary across different segments and markets of the investment banking industry, and how they affect the performance and competitiveness of different types of investment banks.
4. The literature review did not address the potential impact of diversification on social and environmental issues, such as financial inclusion, corporate governance, or sustainability. Future research could explore how investment banking diversification affects the social and environmental responsibility of investment banks and their stakeholders, and how it aligns with the broader goals of financial stability and economic development.

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