

# Commercial Bank Diversification: A Theoretical Survey

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## Abstract

*The banking industry in the entire world has experienced tremendous diversification levels spurred by the sector liberalization and deregulation in the last two decades. This is especially so because of the competitive pressure that has resulted from non-bank institutions entry into the sector as well as the resulting reductions in cost efficiencies and profit margins earlier associated with the intermediation business. While banks have resolved to creative diversification strategies to overcome the profit compression and competition pressure, a number of questions central to this practice still linger and which this paper seeks to address. First, what is diversification in banking? Though, it is clearly defined in strategic management literature, the true meaning of diversification in banking has remained elusive. Secondly, what is the theoretical motivation behind firms and managers pursuit of diversification? Lastly, what are the avenues through which banks can execute a diversification strategy? The research find out that bank diversification is best understood by disaggregating the various elements that constitute the operations, assets and liabilities of commercial banks and can be defined as the conglomeration of different activities, income sources, assets and liabilities in banking operations. The theoretical diversification of diversification stems from the search for market power hypothesised in market power theory, the exploitation and utilization of resource bundles to attain sustainable competitive advantage as proposed by the resource based view theory or pursuing of managerial self interests hypothesised in agency theory. The common approaches through which banks pursue diversification are income diversification, assets diversification, credit diversification, geographical diversification and international diversification.*

## Keywords

*Diversification, Theories, Approaches, Commercial Banks*

## I. Introduction

Global market technologies and macroeconomic pressure pushed a lot of economies to liberalize and deregulate banking industries in the 1990s. This has triggered enormous diversification in banking world over. An example in case is the Second Banking Directive of 1989 which allowed European banks to pursue functional diversification across activities such as commercial banking, investment banking, insurance and other financial services (Baele et al., 2006). In America, the 1999 Gramm-Leach-Bliley Act allowed banks to expand into more non-interest banking activities (Ebrahim and Hasan, 2008; Elyasiani and Wang, 2012). Partly, this diversification has been viewed as a response to competitive pressure from non-banking players who joined the industry as a result of the liberalization (Edwards and Mishkin, 1995). However, the response hypothesis does not seem sufficient. This review therefore sought to answer the following three central questions on diversification; first, what is diversification; Secondly, what is the theoretical motivation behind diversification; and third, what are the various avenues for diversification available to banks. Whereas the first question seeks to define diversification – both generally and in the context of banking institutions – the second questions provides a review in the theories of diversification. The third question provides a discussion into the approaches of diversification that banks can exercise.

## II. The Concept of Diversification

There is no consensus on the precise meaning of the concept of diversification among researchers. As argued by Reed and Luffman (1986), the term “diversification” would have different meanings when research interests varied. Its definitions are many and therefore what is needed is a comprehensive definition which is both theoretically sound and managerially valid (Olo, 2009). Some researchers have thus defined diversification in terms of the number of products, services and markets (Gort, 1962; Berry, 1975) while others define it in terms of the means and methods

that enable organizations to achieve growth and reduce overall risk (Markowitz, 1952; Hoskisson and Hitt, 1990). Generally, diversification refers to the increase by a firm of the number of business lines it runs whether such lines are related or not (Penrose, 1959). According to Olo (2009) the grand strategy involving diversification represents a distinctive departure from the firm's existing base of operations to a separate business line either through acquisition or expansion. A firm is considered diversified when it conglomerates two or more activities in its operations or operates in more than one locality. For instance, while analysing the effects of funding diversification on credit unions' performance, Mulwa (2013) considered a credit union to be diversified when it used more than one source of financing to raise funds.

In banking, diversification is done functionally by combining into what is called a conglomerate such activities as commercial banking, securities trading, insurance and other financial services (Baele et al., 2006) or forming a conglomerate of many banks through a bank holding company or banking groups (Kahloul and Hallara, 2010). Indeed Ebrahim and Hasan (2008) defined bank diversification as the expansion into new financial services and products other than the traditional intermediation activities. In his review of the benefits of relaxing the Glass-Steagall Act (Banking Act) of 1933, Christiansen and Pace (1994) defined diversification as the expansion of a banks allowable activities into non-traditional banking activities. This definition was also emphasized by Tabarrok (1998) in his review of the recommendations of the Glass-Stegall Act which had advocated for separation of commercial and investment banking activities. As such bank diversification can be better understood by disaggregating the various elements that constitute the operations, assets and liabilities of a commercial bank. In this regard, bank diversification can thus be defined as the conglomeration of different activities, income sources, assets and liabilities in banking operations.

### III. Theories of Diversification

The second central question in this review was why managers and firms pursue diversification. This question can be split in to two components; managerial and prescriptive components. The managerial component seeks to understand what informs managerial behaviour in choosing diversification as a strategic move while the prescriptive component justifies the outcome expected from diversification. As such a good theory of diversification should thus be both managerial and prescriptive. The motives behind corporate diversification are numerous and include; the synergistic motive, the financial motive advanced in portfolio theory, the market power motive, the resource motive, the agency motive occasioned by managerial discretion, and the cost efficiency motive (Montgomery, 1994; Olo, 2009; Yuliani et al., 2013).

Montgomery (1994) identified three key theoretical motivations behind diversification: the search for market power; the solution to agency problems; and the application of resource bundles to attain a competitive advantage. These motivations correspond to the market power theory, the agency theory and the resource based view theory respectively and explains the reasons as to why firms diversify. The market based view theory and the resource based view theory are prescriptive and explain the motives of firm diversification based on profit maximization. Agency theory on the other hand is managerial and emphasizes managerial choices and self interest as a basis for diversification. The following subsections discuss the three theories

#### A. Market Power Theory

The argument for market power builds from Porter (1980) opinion of positioning the company in its environment using a set of strategies that distinguishes a firm's position among the competitors. One of the strategies to overcome competition is diversification (Barney, 1991; 2002) which enables firms to build market power granting them access to conglomerate powers. By entering other markets through diversification, firms are able to gain competitive power in the market not because of their particular position in that market but because of their positions in other markets. In deed Gribbin (1976) argues that in order to attain conglomerate power, a firm must first have individual power in its individual market. This power then propels the firm to enter new markets through predatory strategies supported by its position, resources and strength in its current market.

Montgomery (1994) identifies three means by which firms are able to yield market power through diversification: cross subsidization by using profits from one market to support predatory pricing in another; mutual forbearance of rigorous competition among competitors; and reciprocal buying among units of a multi-business firm which forecloses small competition. This was confirmed by Palich et al., (2000) who content that firms with market power can easily control market prices by offering discounts, cross subsidies and practicing reciprocal purchasing and selling as tools to prevent potential competitors entering the industry. This way firms are able to overcome competition thereby earning profits above the average market profits. Therefore market power theory prescribes diversification as a tool for enhancing the financial performance or profitability of a firm.

#### B. Agency Theory

Agency theory hypothesises that separation between the owners and managers of company creates divergence of interests which

ultimately increase the agency cost. These costs refer to the aggregate of: the agent incentive costs and monitoring costs incurred by the principals in limiting the divergence of interests; bonding costs incurred to deter the principals from taking interest diverging actions; and the welfare reduction or residual loss incurred by the principal as a result of the divergence between the agents decisions and welfare maximizing decisions expected by the principals (Jensen and Meckling, 1976). Managers would often deploy corporate assets for their own selfish interests rather than the interest of the stock holders. These problems are usually exacerbated by differentials in risk preference between the agents and the principals (Jensen, 1986). Often, shareholders are more concerned about the systematic risk while managers are more interested in unsystematic risk which conflicts are more pronounced in companies with substantial free cash flows. This is so because the managers will chose to invest the excess cash flows to optimize profits and not to increase cash payments to shareholders.

Diversification is usually a convenient vehicle for this managerial behaviour (Jensen and Meckling, 1976). According to Jensen (1986), managers with free cash flows are likely to undertake value destroying or low benefit diversification to grow the size of their business territories, for managerial entrenchment or for reducing total firm risk which benefits their personal positions. The consequences of these decisions border on agency costs because according to Montgomery (1994) they can be viewed as managerial perquisites intended to decrease the risk associated with managerial human capital. Agency view emphasizes the benefits accruing to managers at the expense of the stock holders as a result of the manager's decisions. Accordingly the view explains why managers pursue diversification and predicts a negative impact of diversification on firm performance.

#### C. Resource Based View (RBV) Theory

Resources Based View approach (Wernerfelt 1984; Barney 1991; Teece et al., 1997) is based on the assumption that firms undertake deliberate managerial efforts steered towards attaining a sustainable competitive advantage. The approach analyses firms as a collection and sets of resources which idea was began by Edith Penrose in her 1959 seminal work "the theory of the growth of the firm" and further advanced by Rubin in his 1973 work on "Expansion of firms". Penrose's theory gave birth to RBV, which later became one of the most dominant approaches to the analysis of sustainable competitive advantage.

RBV approach enlists the circumstances under which a firm's resources lead to high returns over longer periods of time using Porter's five competitive forces. It explains the resource-benefits accruing to a firm by envisaging the existence of resource position barriers where by the holders of a resource are able to maintain a sustainable competitive advantage in relation to other holders and third persons. This is because possession of a resource by one party affects the costs and / or revenues of later acquirers adversely. In such a case the holder can be said to enjoy the protection of a resource position barrier or a first mover advantage (Lieberman and Montgomery, 1988). Just like entry barriers envisaged in Porter's model, resource position barriers do indicate a potential for high returns since one competitor has an advantage over others occasioned by efficiency in the use of resources (Montgomery, 1994). Indeed Prahalad and Hamel (1990) suggests the emergence of large firms because of the success in building distinctive capabilities based on resource capabilities as a source of sustainable

competitive advantage.

The RBV theory not only provides a prescription for improving a firm's financial performance but also recommends diversification by building on the resource capacities to enter new markets or what Wernerfelt calls the sequential entry strategy. A firm's resource position is beneficial by not only creating entry barriers but also directly by supporting diversification in to related activities which provides cost benefits to the firm. Barney (1991) argue that diversification based on resource capabilities can create economies of scope by sharing activities and core competences transfer as a source of sustainable competitive advantage.

The essence of RBV is an action strategy to position a business unit as a foundation for a multi-business firm and emphasizes the firm's ability to exploit the potential synergies between resources to produce higher performance. Therefore potential diversification based on RBV focuses on resource allocation and sharing competencies across different business lines to enhance performance by either cost reduction or by playing competitors out of the market as the absolute volume per period increases (Porter, 1980). This exploitation of potential synergies expected from sharing functions, resources and competencies lead to generation of sustainable competitive advantages and thus profitability occasioned by cost reduction. Therefore, the RBV predicts a positive impact of diversification on a firm's financial performance.

#### IV. Approaches to Bank Diversification

The third and last question of concern in this review was about the various approaches through which commercial banks can practice diversification. Theory of bank diversification suggests the existence of several types of diversification which include amongst others, geographical diversification, international diversification (Lin, 2010; Obinne et al., 2012), income diversification (Gambacorta et al., 2014; Kiweu, 2012), product or services or activities diversification (Christiansen and Pace, 1994), deposit diversification, asset diversification and diversification into different economic sectors (Berger et al., 2010; Goetze et al., 2013). Liang and Rhoades (1991) argued that banks can diversify by investing in financial securities, participating in Fed funds and other securities in addition to making loans. Though Ebrahim and Hasan (2008) called this product diversification, it is closely related to the income diversification pointed out by Kiweu (2012). Additionally, Liang and Rhoades (1991) provide that banks can also diversify their loan portfolios across different types of loans in addition to being geographically diversified. Close to this, Saksonova and Solovjova (2011) argued that commercial banks can diversify not only their lending portfolio but also their investments. However, the key and common diversification strategies in banking are; income diversification, assets diversification, credit diversification, geographical diversification and international diversification.

Income Diversification can be defined following Ebrahim and Hasan (2008) as the expansion into new income earning financial services other than the traditional intermediation services. Indeed income diversification involves the combination of or generation of income from distinct income generating activities (Baele et al., 2006; Kiweu, 2012; Gambacorta et al., 2014). This basically involves the shift of reliance from the interest income sources associated with traditional intermediation activities to innovative non-interest income earning activities (Doumpos et al., 2013; Stiroh, 2002; Kiweu, 2012; Elyasian and Wang, 2012; Calmes

and Theoret, 2013). Income diversification can be measured using the Herfindahl-Hirschman Index and the Entropy Index which accounts for the variations in the breakdown of net operating income into interest income and non-interest income (Stiroh and Rumble, 2006; Tabak et al., 2011). Closely related to income diversification is assets diversification which involves the distribution of a bank's earning assets across lending assets and non-lending assets (Goetz et al., 2013). According to Doumpos et al., (2013) and Elsas et al., (2006), assets diversification is measured as the sum of squared shares of net loans and other earning assets to total earning assets subtracted from unity to get a value that increases with diversification.

Another approach through which banks can pursue diversification is the diversification of credit lines. This involves the diversification of loan portfolio across different sectors, industries or geographical localities (Acharya et al., 2006; Chen et al., 2013; Turkmen and Yigit, 2012; Behr et al., 2007; Tabak et al., 2011). The basic premise behind credit diversification is the project distribution or reduction of risks per entrepreneur by adding independent risks in the portfolio (Diamond, 1984). This may however not be the case as the firm's monitoring efficiency is reduced as the number of sectors are added to the portfolio (Acharya et al., 2006). A comprehensive measure of credit diversification is the general diversification indices of Herfindahl-Hirschman Index (Acharya et al., 2006; Chen et al., 2013; Jahn et al., 2013) which ranges from zero indicating complete concentration with higher values of the index indicating more diversification (Jahn et al., 2013).

Geographical diversification is another approach through which commercial banks can pursue diversification strategies. This involves proliferation of branches and service outlets across a geographical boundary, often a country. Indeed Obinne et al., (2012) defined geographical diversification as the opening of branches by a bank outside the head office location while Goetze et al., define it as the spread of bank's assets across different geographical points. Closely related to geographical diversification is international diversification which entails a cross-border expansion of bank outlets either through branches or subsidiaries (Berger et al., 2010). Both geographical and international diversification is pursued either to increase outreach or disperse country specific risks (Lin, 2010). Mostly, geographical and international diversification are measured using dummy variables (Obinne et al., 2012) or as a proportion of distant branch's or overseas subsidiary's assets related to that of head office or subsidiary company (Lin, 2010).

#### V. Conclusion

The deregulation and liberalization in the banking sector in the last two decades has increased competition by allowing non-banking players to join the industry. To mitigate the increased competition, banks have diversified their portfolios away from traditional intermediation into new geographical areas and new products such as banc-assurance and brokerage services. Further, traditional banking business has been undercut by fundamental economic forces and its profitability has diminished forcing banks to turn to new non-traditional activities (Edwards and Mishkin, 1995). Competition has also diminished bank cost advantages in raising funds as well as their profitability. To survive, banks have two alternatives: expanding traditional lending activities into new riskier areas and, secondly, pursuing new off-balance sheet activities that are more profitable. These have led to tremendous diversification levels in the banking sector throughout the world as commercial banks have responded by raising their involvement



in non-traditional intermediation services such as investment banking and banc-assurance and venturing in areas that were once viewed as risky (Gamra and Plihon, 2011). Additionally, banks have considerably grown their networks by opening new branches in areas that were earlier considered unprofitable (Central Bank Kenya Bank Supervision Annual Report, 2012).

Theorists have explained this behaviour in various ways and provided prescriptive outcomes of the diversification, both favourable and unfavourable. Whereas the resource based view theory, and market power theory predict better firm performance as a result of either economies of scope, cost efficiency, resource sharing or building a sustainable competitive advantage, the agency theory associates diversification to value destruction occasioned by managerial entrenchment, empire building and managerial self efficacy especially for firms with free cash flows (Montgomery, 1994). Literature also identifies a number of avenues through which commercial banks pursue diversification, namely; income, assets, credit, geographical and international diversification.

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