Diversification, efficiency and risk of banks: New consolidating evidence from emerging economies

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Summary

The recent decades have witnessed a significant shift of banks' business to non-traditional areas in response to increasing competition, changed regulatory policies, the innovation of management skills and new technology. This paper examines the impact of business diversification of banks on their risk-

taking behavior and business efficiency. Using bank-level data from more than 1400 commercial banks in 39 emerging economies during the period of 2000-2016, we find that bank diversification, both from the income side and funding side, increase bank stability (or decrease bank risk) significantly. These favorable effects of business diversification on bank risk are achieved by large direct effects, which are partially offset by unfavorable indirect effects of diversification, caused by the (in)efficiency channel of the implementation of bank business diversification.

This pattern of the diversification-efficiency-bank risk nexus is confirmed well for income diversification by small banks, banks with low market power and privately-owned domestic banks.

Interestingly, in contrast to privately-owned domestic banks and state-owned banks, foreign banks are shown not to be benefitted from bank diversification activities. Our paper provides a consolidating evidence on the competing arguments on the diversification-efficiency nexus in banking—the "diversification-premium" argument vs. the "diversification-discount" argument—with its extended implications on banks' risk-taking behavior in emerging economies.