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Influence of Diversification on the Financial Performance of Commercial Banks in Kenya

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Abstract

Diversification has been found to play an important role in improving the financial performance of commercial banks. However, it has been observed that although most of the commercial banks in Kenya are diversified, they have continuously experienced insignificant growth and unstable financial performance. The poor performance has resulted to some of them being put under receivership and others acquired. The main objective of this study was to determine the influence of diversification on the financial performance of commercial banks in Kenya. The target population consisted of all the 39 commercial banks in Kenya over the period 2011 to 2020. Income and asset diversification were both measured using adjusted Herfindhal-Hirschman index (HHI). Geographical diversification was measured using natural logarithm of number of branches. The t-test was used to determine the significance of the model and also test hypothesis. Data analysis for both descriptive and inferential statistics was undertaken using EViews statistical software. The findings were that income diversification had a significant inverse relationship, geographical diversification had a significant positive influence while asset diversification had no significant influence on financial performance of commercial banks in Kenya. It was recommended that commercial banks in Kenya should not diversify their income streams since it reduces their income. Attempts to diversify their assets should be avoided since it was found to be not statistically significant. There is need for the banks to diversify more geographically by establishing more branches both within and outside the country where unbanked market potential exists.

Keywords: Diversification, Financial Performance, Commercial Banks

Introduction

Diversification is defined as the process of bringing together diverse assets which have different levels of risk so as to lower the general risk associated with the entire portfolio of an organization. In the banking industry, diversification is usually used in order to manage risk and improve performance given the critical role they play in the allocation of economic resources by channeling funds from depositors to investors (Ongore & Kusa, 2013). Diversification mitigates systemic risk facing a commercial bank and thus reduces the probability of bank failure. There are various ways in which commercial banks in kenya have embraced

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diversification and these include offering new services such as mobile banking, agency banking, bank-assurance, faceless banking and integrating microfinance in their banking system (Ndungu & Muturi, 2019).

There are three main reasons why commercial banks adopt diversification. The first reason is to enable it to extend its corporate parenting capabilities into new markets and products. The second reason is to achieve efficiency by maximizing the company's resources using new products to new customers and geographical locations. Lastly, a bank may venture into diversification because it wants to increase its market power by having diverse range of products and services (Kitisya, 2017). Diversification in banks can be based on three perspectives which include income, asset and geographical location. Income diversification can be defined as the act of venturing into new income earning financial products and services other than the usual intermediation services (Hassan, 2017). Income diversification in banking can take two dimensions that is interest and non- interest income. Non- interest income includes fees, net trading and other non-lending banking activities (Bush & kick 2009). In asset diversification, banks may hold assets in form of financial assets, loans, cash and cash equivalent and other investments. Geographical diversification can be defined as a firm's business expansion into different locations or markets,(Hitt *et. al,* 1997). It entails the number of activities that a firm undertakes in different regions. Geographical diversification involves spreading bank operations across many markets within and across countries. The banking industry's steady shift from the local region to other foreign regions has been at the heart of a large body of literature in corporate and banking finance (Ongore, & Kusa, 2013).

Financial performance is the capabilities to perform profitably, efficiently and effectively, being able to withstand all the hard economic times, environmental threats while utilizing the available resources and existing opportunities to the maximum with minimal cost (Nyakundi *et al.,* 2014). Financial performance in Kenya commercial banks is measured quarterly as per the central bank regulation. This can easily be done by study of financial statements since they capture all information on each portfolio and their contribution. Financial performance is important as it is one of the elements that shows whether a firm is profitable or not (Boru, 2011). Hitt (1996) in his study depicted that financial ratio parameters can be used to enable stakeholders of the business determine how their businesses are faring on as far as financial performance is concerned.

Empirical evidence is equivocal on the influence of diversification on financial performance of commercial banks. Proponents of bank diversification including Buyuran and Eksi (2021); Al Rashidi (2020); Curi, Lozano-Vivas and Zelenyuk (2015); Meslier *et al.*,2016; Vasilescu and Millo (2016) argue that diversification enhance bank financial performance by enhancing managerial efficiency, reduction of operating costs and increased productivity, while opponents of bank diversification (Luu *et al.*,2019; Hoang *et al.*, 2020; Bapat and Sagar, 2015 and Goetz *et al*., 2011), argue that diversification leads to high costs, operation inefficiencies, increased managerial incentives and, diseconomies of scale which leads to poor performance. As such, there is no consensus that has been arrived at empirically as to whether diversification really influences the financial performance of commercial banks in Kenya or not hence need for this study.

Commercial Banks in Kenya

According to Central Bank Supervisory Report 2021, there are of 39 commercial banks in Kenya. The industry has experienced tremendous diversification levels spurred by the sector liberalization and deregulation in the early to mid- 1990s (Mwau, Tarus & Kosgei, 2015). Due to competition, weak governance and technological innovations, commercial banks in Kenya and across the world have been pushed to employ diversification so as to remain profitable and relevant in the banking industry. The banking sector's total income grew by 3.3percent as at 2019 compared to 4.8percent in 2018 (CBK, 2019). Though the overall performance of commercial banks seems to be improving; some individual banks are still facing operational challenges which resulted into mergers and acquisitions. For example, Equatorial commercial bank (2014), Giro commercial bank (2017). Others have been put into receivership, for example Chase bank (2016), imperial bank (2013). Majority of commercial banks have taken major steps in adopting creative diversification to overcome operational challenges which is expected to be a factor to improved financial performance. This Research will seek to address the question of how diversification affects financial performance of commercial banks in Kenya.

The banking industry is fairly diversified with some banks having a country wide branch network and presence in the East African region (Kodongo & Natto, 2014). As far as distribution of branches within the country is concerned, the number of branches decreased from 1,505 in 2018 to 1,490 in 2019, which translated to a decrease of 15 branches. The total assets also had an increase from 413.2 billion in the year 2015 to 665 billion in the year 2019 (CBK Annual Report, 2015; CBK Annual Report, 2018; CBK Annual

Report, 2019).As at December 2019 other assets of the banking sector stood at 422,376 million and rose to 467,112 million as at December 2020.This indicates that banks have embraced asset diversification since they hold a variety of assets (CBK Annual Report, 2020). In terms of income, the banks registered a slight increase from sh. 418 in the year 2017 to sh. 513 billion in the year 2018 to sh. 537 billion in 2019. Other incomes amounted to 55,578 Million in 2019 and 62,961 Million in 2020. This shows that the banks are diversified in terms of income. In terms of profitability of the commercial banks, there has been a dwindling performance over the last three years.

Theoretical Perspectives of Diversification

Banks pursue diversification for different intentions which include financial, market power and the resource motive which is aimed at improving financial performance. The theories which are regarded essential in explaining why firms pursue diversification are the Market power theory and Resource based view theory. According to Mulwa et al. (2015), the market power theory and the resource based view theory are prescriptive and explain the motives of diversification based on profit maximization.

Market Power Theory

The argument for market power originated from Porter (1980) opinion of positioning the company in its environment through adoption of strategies which can help it stand out among its competitors (Amoah, 2019; Hassan, 2017; Mochabo, Benedict & Ondiek, 2017; Mulwa *et., al.* 2015).The market power theory states that performance of a financial institution is influenced by the market structure of the industry. This theory advocates for firms setting up strategies that will enable them distinguish their position in the environment from the positions of other competitors and this can best be achieved through diversification (Mulwa *et. al.,* 2015). Diversifications of a firm's operation help to build market power by granting access to get right of entry to new market and conglomerate powers as well. By way of getting into different markets via diversification, firms are capable of benefiting from competitive power within the market not because of their specific position in that market but because of their positions in different markets (Amoah, 2019). This is because diversification is perceived to enable a firm to achieve competitive power in the market because of its position in other markets (Mulwa et al. 2015). This claim is supported by Al-Muharrami and Matthews (2009) who held that firms with greater market power may take advantage of the gains from non-competitive pricing in a more relaxed environment in which less effort is put into the rigours of minimising cost. Therefore this theory is relevant in this study since it will seek to know whether

the banks' geographical diversification to these new markets have benefited them by improving their financial performance. It is expected that the banks should have embraced geographical diversification so as to venture into new markets and also stretch their hand on income diversification in an effort to broaden their portfolios.

Resource Based View Theory

This theory was proposed by Wernerfelt (1984) and holds that banks can have different resources and capabilities which can be attributed to the various technologies they use for diversification of products (Barney & Hesterly, 2011). Thus the RBV encourages banks to diversify when it has excess resources so as to earn more productivity. In support of this claim, Thiong'o (2017) observed that by combining the various resources and capabilities of a firm,banks are able to stay afloat in the competitive area in relation to time saving, reduction of operation cost, business agility and quality of service. In this case, a firm will maily focus on exploitation of those resources that offer the most sustainable competitive position, since it cannot use all of its resources at once. In order to generate sustainable competitive advantage, the firm should ensure that it keeps its resources and capabilities rare, difficult to imitate, valuable, non-substitutable and nontransferable (Arasa, 2014). This theory is supportive of this study in the sense that the banks that have embraced asset and income diversification are expected to record superior performance as a result.

Research Methodology

The study used secondary data which was obtained from the Central Bank of Kenya annual supervisory reports. Only data for the relevant period of study, 2011 to 2020, were extracted and analyzed. The study used secondary data because the variables are quantitative in nature and could be well measured using secondary data. Financial performance was measured by using return on assets (ROA) which was calculated by dividing the net income by the value of total assets (Teimet *et al.*, 2020). Consistent with Stiroh and Rumble (2006), income and asset diversification were measured using the Herfindahl-Hirschman Index (HHI). The HHI captures variations in the various components of asset and income diversification computed as sum squared shares of the individual components to total income or assets subtracted from unity to get a value that increases with the degree of diversification. Geographic diversification was measured as the firm's expansion into various geographic locations or markets within a country (Ahmed & Simba, 2019). To measure geographical diversification, the study used natural logarithm of the number of branches of each bank.

The study adopted a multiple regression model to determine the link between the dependent variable (financial performance) and independent variables under study (income diversification, asset diversification and geographical diversification). The model is presented as shown below;

$Y_{it} = \beta_0 + \beta_1 X_{1\,it} + \beta_2 X_{2it} + \beta_3 X_{3it} + \varepsilon_{it}$

Where, Y_{it} represents financial performance, X_1 represents income diversification, X_2 represents asset diversification, X_3 is the geographical diversification, $_i$ is the number of companies analyzed $_{,t}$ is the time in years from 2011 to 2020, $\beta_0, \beta_1, \beta_2$ and β_3 are the parameters of the equation and ε is the error term.

Table 1 presents summary of data while table 2 presents the correlation results among variables.

Table 1: Descriptive Statistics of Variables

	Minimum	Maximum	Mean	Std. Deviation
Financial Performance (ROA %)	-19.8100	7.7000	1.8876	2.9740011
Income Diversification (HHI)	0.00160	0.5000	0.3008	0.1095850
Asset Diversification (HHI)	0.11300	0.5000	0.4498	0.0521208
Geographical Diversification (*ln.* Branches)	1.09860	5.3132	3.04765	1.1190932
Valid N (listwise) = 300				

Source: Research Data (2022)

Table 2: Correlation Coefficients

	[1]	[2]	[3]	[4]
[1] Financial Performance	1			
[2] Income Diversification	-.076	1		
[3] Asset Diversification	.208**	-.031	1	
[4] Geographical Diversification	.309**	.444**	.091	1
**. Correlation is significant at the 0.01 level (2-tailed); N=300				

Source: Research Data (2022)

Statistical Quality Tests

Regression analysis requires the testing of certain assumptions before analyzing the data to avoid making unreliable conclusions. When dealing with panel data, multicollinearity, and normality of variables and errors have to be tested to avoid making untrustworthy inferences about parameter coefficient due to biased estimates (Kennedy & Bush, 1985).The assumption tests which were carried out are: test for panel multicollinearity, test for normality of variables and errors and linearity in parameters test. Additionally panel data was used which requires test for stationarity to test whether data is fit for analysis (Gujarati,

2004). Multicollinearity test was carried out to establish if there were any independent variables that are correlated to each other in the model. The study used the tolerance and variance inflation factor (VIF) to test for multicollinearity in predictor variables. A tolerance of below 0.10 or a VIF greater than 10 or a correlation coefficient above 0.8 is regarded as indicative of serious multi-collinearity problems (Field, 2009). All the variables had tolerance values exceeding 0.1 and VIF values below 10 indicating that there was no multicollinearity problem among the independent variables. The normality assumption was conducted to test whether or not variables under study have values that exhibit normal distribution. To achieve this, the study conducted the Jarque Bera test. The probability of the Jarque-Bera statistic for all the variables were less than the critical value of 0.05 indicating that the variables were not normally distributed. Similarly, the Jarque-Bera (JB) test for normality was used to test for normality of error terms. According to Brys *et al.*, (2004), the JB test tests the hypothesis that the distribution of error terms is not significantly different from normal [H_0: E (ε) ~N (μ=0, var. =δ^2)]. From the results, the significance level for the JB statistic is less than the critical p-value of 0.05 implying that the random error term was different from normally distributed (Tanweer, 2011). A model relating the response variable to predictors is normally assumed to be linear in the regression parameters (Charterjee & Hadi, 2012). Following Osborne and Elaine (2002), the parameter linearity assumption was tested by plotting residuals against the predicted values of the response variable with the relationship expected to take a linear form. The various points in the graph were spread along a linear line cutting through the origin and therefore the linearity assumption was met.

Stationarity of panel data test was carried out to establish whether a time series data has stationarity. This ensures that shift in time does not cause change in the shape of its distribution. It was done using the Augmented Dickey-Fuller (ADF) unit root test. The ADF test usually test the null hypothesis that the Panel data contain Unit roots against the alternative hypothesis that the panel data are stationary. The p-values of the ADF-Fisher Chi-square statistic for all the variables except asset diversification were less than the critical p-values of 0.05. This implies that all the variables except asset diversification were stationary at level and therefore suitable for analysis (Dickey & Fuller, 1979; 1981). To correct for non-stationarity in asset diversification, the first difference of the variable [D (var)] was used in the regression models. The first difference of a variable is the series of changes from one period to the next (Dickey & Fuller, 1979; 1981).

Results and Discussions

Income Diversification, Asset Diversification) and Geographical Diversification were regressed against financial performance at 5% significance level. The results show that there was a significant regression relation between the indicators of diversification and financial performance as indicated by the significant LR statistics (LR statistics =54.27002, Prob. =0.0000<0.05).

Income diversification had a negative coefficient of -8.690285 and a probability value of 0.0000. The relationship between income diversification and financial performance is significant since the probability value (0.0000) is less than the significant level of 0.005 (p-value =0.000<0.005). The findings of this study corresponds with the findings of several prior studies. For instance Hoang, *et. al., (*2020) in Vietnam found that there was an inverse relationship between income diversification and both profitability and overall financial performance of Commercial banks. Similarly Luu, Nguyen, Vu and Tuan (2019) in their study on the impact of income diversification on financial performance of commercial banks in Vietnam revealed that while diversification benefited positively state-owned and foreign banks, it exhibits a detrimental effect on the financial performance of other non-state owned domestic banks. Similar findings were also reported by Molyneux and Yip (2013) in their study which interrogated the effect of income diversification on the performance of Islamic banks in Malaysia revealed that income diversification on its own increases income volatility and this negatively impacts banks' overall financial performance.

Asset diversification had a positive coefficient of 1.389996 and a probability value of 0.6687. The relationship between asset diversification and financial performance of commercial banks is insignificant as shown by the probability value which is greater than the significant level of 0.005 %, (p-value =0.6687 >0.005).The results confirm the findings by Rop, Kibet and Bokongo (2016) in Kenya that asset diversification was insignificant. Similar findings were recorded by Elefachew and Hrushikesava (2016) whose study on the effect of industrial diversification on financial performance of selected banks from Ethiopia, disclosed the existence of an insignificant relationship between asset diversification and financial performance. Thiong'o (2018) also reported that banks that hold a high level of liquid assets performed poorly financially.

Geographical diversification had a positive coefficient of 1.2175 and a probability value of 0.000. The relationship between geographical diversification and financial performance is significant as the probability

value is less than the significant level of 0.005% (p-value =0.000 <0.005).The findings of this study agree with several prior studies including, Njuguna (2018) who carried a study in Kenya showed that there was a positive relationship between geographical diversification and financial performance. Meslier, *et.al.* (2016) based on their study in United States on the benefits and costs of geographic diversification in banking among the commercial banks found out that geographic expansion was highly embraced by the banks because it was perceived to assist in minimizing bank risk thus improving on financial performance. Also, Ndungu and Muturi (2019) reported that geographical diversification had a positive effect on the financial performance of commercial banks in Kenya.

Table 3: Data Analysis Results

Dependent Variable: Financial Performance
Method: Generalized Linear Model (Quadratic Hill Climbing)
Sample (adjusted): 2012 2020; Included observations: 270 after adjustments
Family: Normal; Link: Identity

Variable	Coefficient	Std. Error	z-Statistic	Prob.
Income Diversification	-8.690285	1.777244	-4.889753	0.0000
D(Asset Diversification)	1.389996	3.248603	0.427875	0.6687
Geographical Diversification	1.217534	0.170239	7.151917	0.0000
Constant	0.616584	0.566964	1.087519	0.2768
Mean dependent variable	1.791704	S.D. dependent variable		3.022430
Sum squared residual	2040.939	Log likelihood		-656.1987
LR statistic	54.27002	Prob.(LR statistic)		0.000000

Source: Research Data (2022)

Conclusions and Recommendations

This study sought to answer a question on whether diversification influences financial performance of commercial banks. Income diversification is found to have an inverse significant relationship with financial performance. For this reason, there is no need for the commercial banks to diversify their income streams since it leads to reduction of their overall financial performance. It was realized that asset diversification has a non-statistically significant influence on the financial performance of commercial banks. The study observed that geographical diversification has a strong positive influence on the financial performance of the commercial banks. For this reason, there is need for the banks to diversify more geographically by establishing more branches within the country. In reference to resource based view theory, geographical diversification is supported by the theory since there are resources that are utilized across the different branches. This resources include managerial capability of directors and other infrastructure that improves

on financial performance of the banks. According to market power theory, for an organization to survive, it must deploy a set of strategies which distinguishes it from its competitors positioning it in in a suitable market level (porter, 1990).

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