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Should banks diversify or focus? Know thyself: The role of abilities

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ABSTRACT

The paper investigates whether diversification/focus across assets, industries and borrowers affects bank performance when banks' abilities (screening and monitoring) are considered. The initial results show that diversification *(focus)* at the asset, industry and borrower levels is expected to decrease *(increase)* returns. However, once banks' screening and monitoring abilities are controlled for, the effect of diversification/focus either gets weaker or disappears. Further, in some cases, these abilities enhance banks' long-run performance, but in others they prove to be costly, at least, in the short run. Thus, the level of monitoring and screening abilities should be taken into consideration in understanding, planning and implementing diversification/focus strategies.

1. Introduction

"Know thyself (yourself)" has been praised as wise advice almost since the beginning of written history. Leaving philosophical discussions aside, an entity's understanding of its own capabilities and abilities is proposed to be necessary for its continuous survival and long-term success; like birds that have the ability to fly to survive and succeed in their respective environments. However, not all birds fly, or the extent of their flying ability differs. Some birds optimize their other talents, for example penguins are great divers and swimmers, and ostriches are amazing runners. They remained highly competitive and efficient and adapted to their respective environments. Organizations, another kind of entities, should also be aware of their abilities and adapt for continuous survival and long-term success in their respective environments.

Bank diversification/focus strategies and their impact on performance and stability have been an intriguing theme of discussion in the academic literature and beyond. In a nutshell, two strategies and their impact on firm performance can be broadly summarized as: diversification is more beneficial in terms of reducing unsystematic risk (*"Do not put all your eggs in one basket"*), collecting and utilizing customer information (Fama, 1985), whereas focus is more beneficial in terms of reducing agency problems and utilizing expertise (Jensen, 1986; Berger and Ofek, 1995; Denis et al., 1997) and other acquired abilities (*"You may put all your eggs in one basket, and watch that basket"* (Winton, 1999)).

A successful bank asset management strategy needs to make optimal decisions on allocation and diversification across different assets and industries, as well as on loan/borrower screening/selection and continuous monitoring. It is similar to the modern framework of portfolio management, where the performance of a portfolio is attributable to a top-down process involving asset allocation, industry diversification, and stock screening/selection, followed by close monitoring. Both asset and industry

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diversification are important for banks, given that banks, by their very nature, are designed to diversify (Winton, 1999; Acharya et al., 2006). Diversified banks may reduce the expected costs of financial distress or bankruptcy by lowering risks through spreading operations across different products or industries (Boot and Schmeits, 2000). Classical bank studies consider banking institutions as unique types of corporations, and the delegated monitoring argument suggests that banks should diversify because it is optimal to do so from the financial intermediaries' perspective of monitoring (Diamond, 1984; Boyd and Prescott, 1986). On the other hand, corporate finance theory suggests that corporations should focus in order to reduce possible agency problems and utilize management expertise (Jensen, 1986; Berger and Ofek, 1995; Denis et al., 1997). As for banks, focus may lead to better screening and monitoring practice[1] and enable the detection of borrower financial problems and fast reactions to mitigate risk (Beck and De Jonghe, 2013). Banks, as financial intermediaries, reduce information asymmetry through loan screening and monitoring (Bhattacharya and Thakor, 1993). Via loan/borrower screening/selection and monitoring, banks allocate the financial resources in the economy efficiently by being able to differentiate good loans/borrowers (i.e., low credit risk) from bad loans/borrowers (i.e., high credit risk) through collecting the proprietary information of the (potential) borrowers (Fama, 1980, 1985; James, 1987; Sharpe, 1990; Rajan, 1992) and acting as the delegated monitors (Diamond, 1984). In this sense, banks have some important differences compared to mutual funds or industry firms. Nevertheless, the screening (ex-ante) and monitoring (ex-post) abilities of banks are highly important for survival and success in the financial industry, and are expected to serve the economy positively.

The existing banking diversification literature tends to focus mainly on asset- and industry-level diversification, while borrower-level diversification has not been studied regardless of its importance. Additionally, with regard to asset and industry diversification, there is no consensus yet on whether banks benefit from being diversified or from being focused. Moreover, in terms of selection and close follow up, screening and monitoring abilities are intuitively related to loan/borrower level analysis, and consequently to industry- and asset-level diversification.[2] However, the existing banking diversification literature largely fails to treat other important components, such as loan screening/selection and monitoring in an integrated asset management framework.

The recent worldwide financial crisis, which includes many instances of large bank failures, raised serious concerns among legislators, practitioners, and academics[3] as to whether banking institutions have outgrown their optimal scope and/or whether banks have overwhelmingly (and too optimistically) relied on asset and industry diversification while failing to do a good job in loan screening/selection and monitoring, which eventually causes banks to perform poorly and/or exposes them to very high risk. This question is an important one because it not only demands ex-post evaluations of the economic impact of changes in the legislative codes on the banking industry *(which might provide an exogenous motive for banks to diversify and/or focus on loan screening)*, but also mandates a careful re-investigation of focus-diversification strategies and the risk-return tradeoff that integrates asset allocation, industry diversification, loan screening and monitoring into the same picture.[4]

This study fills this gap in the literature by utilizing a unique dataset *(from a less studied, but highly important developed market: Japan)* and empirically investigating whether diversification across assets, industries and borrowers matters for bank performance *(market and accounting)* when screening and monitoring abilities are in the picture. We ask *"How important is the monitoring and screening ability of banks when they are diversified or when they are focused?"* In particular, we are interested in: (a) When banks are good at loan screening and monitoring, is there still a role for diversification across asset classes, industries and borrowers? (b) When banks are poor/good at loan screening and monitoring, does diversification/focus play a bigger role, or would it not help the banks anyway?

The datasets used in this study cross-match Bankscope, Datastream, Global Compustat, and a unique dataset from Nihon Keizai Shimbun Inc. that provides very detailed and comprehensive loan information (a total of 126,864 loan observations from 3474 borrowers spanning 327 different industry sectors) from Japan. The Japanese economy is the third largest economy *(nominal GDP)* and the second largest developed economy *(World Bank and OECD)*. Among the world's 100 largest banks *(ranked by assets)*, nine Japanese banks with an aggregate asset size of over 10 trillion dollars are listed *(besides Japanese banks, only China (14) and the USA (10) have banks with an aggregate size of over 10 trillion dollars)*.[5] Japanese banks and regulatory institutions have been actively involved in Basel Committee on Banking Supervision activities since the beginning. The Japanese market also presents an interesting setting due to its asset bubble crisis in the late 80 s and early 90 s and the subsequent structural and regulatory changes aiming to stabilize its economy. Although periodical and environmental differences do exist, similarities to the recent global financial crisis are also evident. Keiretsus, Japanese business groups, play a major role in both the Japanese and the global economy. Banks play a dominant role in these business groups, usually managing the group activities and being responsible for coordination among the group-firms. Some banks are specialized in certain industries and markets in terms of their lending. Some have direct or indirect major ownership stakes in their group-firms, which could also be their borrowers. Banks' lending practices could be influenced by the

[1] Screening (ex-ante) ability means that the bank evaluates the borrower and the probability of the loan default before the loan relationship. Monitoring (ex-post) ability means that the bank collects and analyzes borrower data and enforces covenants after the loan relationship (Best and Zhang, 1993; Preece and Mullineaux, 1996).

[2] The implementation of diversification/focus strategies takes time. As an insider, bank management has a sound idea about banks' abilities and strategy implementation. Management utilizes this knowledge at the time of planning and implementation.

[3] For an assessment of the banking sector and asset bubble relationship, see Acharya and Naqvi (2012), for the credit crisis, see Beltratti and Stulz (2012), Diamond and Rajan (2009) and Laeven and Valencia (2013), for an analysis of the value of diversification during crisis, see Kuppuswamy and Villalonga (2012), for the impact of capital on bank performance during financial crisis, see Berger and Bouwman (2013), for crisis and bank opaqueness, see Flannery et al. (2013), for crisis and bank-client relationship Pennathur and Vishwasrao (2014), and for internal capital markets of global banks and liquidity shocks Cetorelli and Goldberg (2012) and De Haas and Lelyveld (2010).

[4] For a discussion on the impact of bank regulation, supervision and monitoring on bank efficiency, see Barth et al. (2013), and for bank supervision and corruption in lending, see Beck et al. (2006), Barth et al. (2009) and Houston et al. (2011).

[5] SNL Financial, World Largest Banks Rankings, December 2013.