DOI:10.18686/ahe.v7i5.7321

The Influence of Income Diversification and Financial Liberalization on the Performance and Risk of Commercial Banks

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Abstract: The potential diversification benefit is one of the reasons why China's commercial banks provide diversified financial services, and is the key issue for commercial banks in their strategic choice and facing fierce competition. The model test results based on the relevant data of 39 commercial banks in China from 2007 to 2014 show that diversification has a multi-dimensional relationship with bank performance and risk under the condition of frequent financial reform measures. Diversification can improve the performance of large commercial banks, but may increase their bankruptcy risk. It will increase the credit risk of medium-sized commercial banks, and has little impact on small-scale regional commercial banks. Under the circumstances of insufficient economic growth momentum and gradual liberalization of financial markets, banks of different sizes should choose different diversified financial services to cope with the impact of changes in the credit scale of financial markets and the reduction of net interest margin between deposits and loans.

Keywords: Income diversification; Performance of commercial banks; Dynamic panel system of financial reform; GMM model

Preface

In recent years, foreign scholars have been controversial about the relationship between bank income diversification and performance and risk. Most studies in the United States and Europe have found that income diversification, especially rich non interest income, can help banks obtain more profits, but also bring more risks, because non interest income is naturally cyclical and unstable (Stiroh, 2004; Stiroh and Rumble, 2006; Lepetit et al., 2008), However, Chiorazzo, Milani and Salvini (2008) confirmed that the situation in some countries was quite opposite. Studying the relationship between diversified income and risk adjusted performance in Italy's banking industry, they found that the two were highly positively correlated, that is, non interest income helped improve bank performance and dispersed risks. At present, more scholars (Sanya and Wolfe, 2011; Pennathur, Subrahmanyam and Vishwasrao, 2012; Meslier, Tacneng and Amine, 2014) have begun to study banks in emerging developing countries with less mature financial systems and different market structures and institutional backgrounds. Studies in developing countries have found that non interest income is beneficial to banks' profits and risk adjusted returns, In particular, more participation of banks in securities and derivative financial products trading in financial markets will bring more profits[1].

But at present, the economic development of emerging economies is generally accompanied by the frequent introduction of financial liberalization reform measures. In the process of financial liberalization, the bank's income diversification strategy will enrich the bank's income channels, but also may bring some risks. Due to the differences in bank size, nature, region and products, this impact will be multidimensional. Therefore, in the context of frequent financial reform measures and gradual maturity of the financial system in China, the study of the impact of commercial banks' income diversification choices on performance (risk) will be able to provide some reference for the theoretical and empirical research of ongoing disputes. This paper examines the data of bank performance and risk measurement from multiple perspectives, including income capacity indicators, risk adjusted earnings indicators, stability indicators and credit risk indicators. By constructing financial liberalization indicators, based on existing research, 39 commercial banks from 2007 to 2014 are selected to test the financial reform The impact of diversification of income structure on the performance and risk of commercial banks.

Literature review

The issue of income diversification of financial institutions has always been a hot topic discussed by scholars. With the change of banking structure and the substitution of other financial resources, commercial banks are constantly looking for ways to increase profits other than loans. According to traditional theories, the diversified income sources of banks will bring scope economy (Klein and Saidenberg, 1997), which brings more profits to banks and disperses the operational risks of banks. Banks can increase profits by eliminating unnecessary business projects and improving asset utilization efficiency, and can also promote the development of other financial services through customer information obtained from loan services. For example, Stiroh (2004) believes that income diversification and increasing the proportion of non interest income can reduce the total risk. Non interest income is generally not completely related to interest income, so it can avoid cyclical changes in bank profits and stabilize bank profits. However, some studies hold opposing views. For example, DeYoung and Roland (2001) refuted the view that income diversification can reduce bank risk, believing that non interest income may increase the volatility of bank profits. High switching costs, high operating leverage and innovation of derivative financial instruments will bring new risks to banks, potentially offsetting the benefits of diversification[2].

Some scholars directly analyzed the impact of non interest income on bank performance and risk, while others directly analyzed the impact of diversified income structure on bank performance and risk. In the process of financial liberalization, the government and regulatory agencies often encourage financial institutions to meet the needs of market competition, scale expansion, liberalization and diversified development through innovative products and building a diversified income structure. As for the impact of diversified income on performance and risk, most scholars have adopted two or more indicators of performance and risk as explanatory variables. Among them, the widely used risk adjusted income indicator more accurately describes the impact of income diversification on performance and risk from the perspective of the income brought by unit risk.

In fact, in the analysis of the relationship between diversified income and risk and performance, the reasonable assumption should be that the transfer of interest income to non interest income can reduce the bank's total risk, because non interest income activities and traditional interest income activities are at least not completely related, and diversified income can form a more stable source of profits. However, DeYoung and Roland (2001), Stiroh and Rumble (2006) have all confirmed that the increase in the proportion of non interest income may bring more operational risks to banks. In some recent studies, DeYoung and Torna (2013) analyzed the impact of income diversification on bank failure during the financial crisis, and found that whether the diversification of bank income during the financial crisis would increase the bank's operational risk was related to the bank's own financial situation, such as some non-traditional businesses with high investment similar to investment banks and proprietary trading businesses would reduce the opportunities for banks with good financial conditions to fail, However, it has increased the probability of bankruptcies of some banks with financial difficulties. The impact of diversified income on risk and performance of European banking industry is basically consistent with the research conclusion of the United States, and the shift to non interest business also increases bank risk. The research of Lepetit et al. (2008) confirmed that banks with a large proportion of non interest businesses face greater risks, especially small banks that mainly rely on commissions and fees. Similarly, Mercieca, Schaeck and Wolfe (2007) also found that for banks with small assets, diversified income has a negative impact on risk adjusted returns. However, Chiorazzo, Milani and Salvini (2008), Italian scholars, obtained the opposite conclusion in their research on Italian banks. They found that the diversified income structure of banks was conducive to risk diversification and improved bank performance, especially for large banks. In view of the impact of diversification on systemic risk, Jonghe (2010) found that non-traditional businesses of European banks would increase β The tail of the coefficient will reduce the stability of the banking system.

Conclusions and suggestions

The performance (risk) of China's commercial banks is not sustainable. The profits and risk adjusted returns of the more mature, large-scale and widely distributed state-owned commercial banks and joint-stock commercial banks are sustainable; The financial stability and credit risk of commercial banks are not sustainable; The effect of income diversification on profit growth and risk diversification is not obvious to the commercial banking industry as a whole; The contribution of non interest income to operating income is not obvious, and its instability and periodicity cannot smooth out the impact of macroeconomic fluctuations on bank income flow.

Therefore, the enrichment and diversification of the income structure of China's commercial banks still need to be adjusted. Based on the above conclusions, China's commercial banks should pay attention to the following aspects in the subsequent process of income diversification and financial development and reform: ① In the process of improving the income structure of commercial banks and increasing the proportion of non interest income, we should also consider whether the selected financial instruments can increase the profits of commercial banks Improve stability (reduce accounting risk and credit risk). For example, banks can avoid financial risk through financial innovation, and find a breakthrough in profit sources from regulatory policies by promoting inter-bank bond market, financial leasing, financial derivative market investment, money market funds, large transferable certificates of deposit (CDs) and other products. ② The rapid economic growth has enabled commercial banks to obtain high profits, but facing the new normal of economic downturn, it is an inevitable trend for commercial banks to reduce profits. How to maintain stability in the crisis is very important. ③ According to the financial reform and development, it is a reasonable choice for commercial banks to find out the optimal proportion of their income structure and non interest income[3].

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