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Income Diversification and Financial Perfomance. Should Banks Trade?

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Abstract

Purpose: The purpose of this study is to examine the effect of income diversification on the financial performance of commercial banks in Kenya.

Design/methodology/approach: The study used a sample of 31 commercial banks and panel data for the period 2008-2017. Data was extracted from the individual bank's financial reports and the Central Bank of Kenya's bank supervision annual reports. The data was analyzed through descriptive and inferential statistics, while the hypothesis was tested using fixed effect regression based on the results of the Hausman test. Financial performance was measured as return on assets (ROA), while Herfindahl-Hirschman Index (HHI) was used to measure income diversification. The study controlled for firm size, firm age and lending strategy.

Findings: The findings indicated that income diversification had a positive and significant effect on banks' financial performance in Kenya. The control variables had varied effects; firm size had a positive effect, while firm age and lending strategy had a negative effect.

Practical implications: The article offers insights to bank managers and the regulator. First managers should consider an optimal level of diversification to compensate for the deteriorating interest revenue. Second, the regulator should relax laws that limit the extent banks can diversify their revenue streams.

Originality/value: Unlike previous studies which focused on developed and emerging economies, this study centered on a developing economy, and the findings are consistent with the propositions of the modern portfolio theory.