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How does the stock market value bank diversification? Evidence from Vietnam

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ABSTRACT

Even though commercial banks have gradually followed the diversification strategy and deeply penetrated into non-traditional businesses for further income sources, studies on potential diversification benefits provide mixed results. This paper investigates how stock market values bank diversification using a data set of Vietnamese listed banks for the period 2006–2014. Overall, we find a negative relationship between bank diversification and stock market valuation. This implies investor preference for banks focusing on traditional activities.

1. Introduction

Important challenges for global banking system are cyclical and structural changes. Since the global financial crisis, banks continue to struggle in a more competitive environment due to the technological developments and the rise of shadow banking. Many commercial banks have been following the diversification strategy to enter into various non-traditional activities as a way to compensate for reduced incomes due to increased competition in core businesses. More importantly, bank governance mechanisms are also reported to be associated with bank diversification (Liang et al., 2016). Given this trend, the question of whether banks should diversify gains importance for different stakeholders (Sawada 2013).

This paper sheds further light on the question how stock market value bank diversification. Particularly, we address the relationship between bank diversification and stock market valuation using the data of banks listed on the Ho Chi Minh City stock exchange for the period from 2006–2014.

Our paper is motivated from different fronts. Firstly, the question of whether banks should diversify is the subject for extensive debate in the current literature. However, the answer to this question remains open as previous papers provide conflicting results (Sawada 2013). More specially, papers using different data set provide inconclusive results. For instance, Baele et al. (2007) assert that diversification increases value and reduces risk in a sample of European banks. On the contrary, Laeven and Levine (2007) argue that diversification reduces value of financial conglomerates using a cross-country data set. Moreover, Stiroh and Rumble (2006) state that the extra risk outweighs the benefits obtain from diversification because the increase in exposure to highly volatile nontraditional bank businesses.

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Secondly, most of previous studies focus on the context of developed markets where banks are at mature development stage while banks in emerging markets are currently at earlier stage of development. However, they are facing many problematic issues. They also need a clear strategy and business model to follow. In addition, the current financial crisis stemming from bank failures highlights the importance to further investigate bank strategy. Further, it is important to investigate bank diversification impacts in different countries because Doumpos et al. (2016) argue that income diversification can be more beneficial for banks operating in less developed countries compared to banks in advanced and major advanced countries.

Thirdly, since Vietnam is an emerging bank-based economy where most of firm financing sources are from bank credit. The banking system plays an important role in fuelling high economic growth in the last two decades. However, we observe a significant change in the composition of Vietnamese bank earnings portfolio in recent years. Vietnamese banks are not only facing competition pressure from other local banks but also from foreign banks as a result of deregulation. We also observe a gradual shift from traditional banking activities into non-interest income activities. This trend is also reported for global banks in many papers (Stiroh 2004; Elsas et al., 2010).

More importantly, the recent development of Vietnamese financial sector provides an ideal setting to study bank diversification strategy.[1] Further, Mirzaei and Kutan (2016) report that the impact of bank diversification might be different in bank-based economies and that of market-based economies. Batten and Vo (2016) recently examine bank risk shifting in the context of Vietnam and highlight that banks shifted to non-interest income businesses face higher level of risk. The current paper builds on previous work of Batten and Vo (2016) in addressing the natural question of how the stock market values bank diversification in emerging markets.

The current paper contributes to the current literature in a number of perspectives. Firstly, this paper complements the literature by focusing the ongoing debate about the relationship between bank diversification and stock market valuation. Secondly, we address this important link in the context of an emerging market. Given the increasing importance of emerging markets, investigating the stock market valuation of bank diversification in Vietnam is an interesting topic on its own merit.

The remainder of this paper is structured as follows. Section two introduces the data and model. Section three presents the results and discussion of the results. Section four concludes the paper.

2. Data and model

2.1. Data

Our dataset covers the market information and bank specific attributes of Vietnamese listed banks. Our data sample incorporates the period from 2006 to 2014.

2.2. Model

We first examine the link between bank diversification strategy and stock market valuation. Our baseline model is specified as follows:

$$\mathrm{VALUE_{it}} = \alpha + \beta \mathrm{DIVERSIFICATION_{it}} + \sum \gamma_h \mathrm{CONTROLS_{it}} + \alpha_i + \alpha_t + \varepsilon_{it} \tag{1}$$

We further evaluate the importance of bank size on the relationship between diversification and stock market valuation. To do so, we formulate the following model allowing for the interaction between diversification and bank size variable:

$$\mathrm{VALUE_{it}} = \alpha + \beta_1 \mathrm{DIVERSIFICATION_{it}} + \beta_2 \mathrm{DIVERSIFICATION_{it}} * \mathrm{SIZE_{it}} + \beta_3 \mathrm{SIZE_{it}} + \sum \gamma_h \mathrm{CONTROLS_{it}} + \alpha_i + \alpha_t + \varepsilon_{it} \tag{2}$$

where: subscripts i and t present bank and time. Other variables are defined as follows.

VALUE is the market valuation indicator. We use two important stock market valuation measures to proxy for stock market valuation. Particularly, we use Tobin's Q and the market to book ratio (MTB) as measures of stock market valuation. Sawada (2013) states that Tobin's Q is likely to have a very small variance due to the nature of banks which are highly leveraged. Hence, we use MTB as another indicator to measure market valuation. MTB is defined as the market value of equity divided by the book value of equity. This indicator is considered to vary more widely than the Tobin's Q ratio (Sawada 2013).

DIVERSIFICATION is a measure of bank diversification strategy. We use the ratio of the net non-interest income to net operating income as a measure of diversification. Particularly, this measure is calculated as follows:

$$NNII = \frac{Net\ Non\ Interest\ Income}{Net\ Operating\ income}$$

CONTROLS are other control variables which potentially explain bank valuation. More specially, our control variables include: SIZE is the log of total assets, OC is the ratio of operating costs to total assets, and L_TA is the ratio of loan to total assets.

[1] Batten and Vo (2016) provide a comprehensive analysis of the Vietnamese banking sector.