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The effects of activity and geographic diversification on performance: Evidence from French financial institutions

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ABSTRACT

Our paper studies the impact of activity and geographic diversification on financial institution's performance. These diversification strategies are complementary in generating performance and may provide important implications. Moreover, we investigate the interaction between these two strategies. Our dataset comprises 4532 years observations over the period of 2002 to 2012 and covers 412 French financial institutions. We find a negative relationship between diversification and performance. However, this relationship is significantly positive when institutions implement a dual diversification strategy. In this paper, we propose a classification of French financial institutions. For generalists' banks and cooperative banks, we find similar results to those of the entire sample. Furthermore, for specialized financial institutions, the relationship is positive and significant. Our findings are robust to the potential endogeneity problem and to measures of diversification and performance.

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1. Introduction

Recently, the liberalization of financial activities, financial globalization and development process of financial innovation have deeply characterized the banking system and the financial industry services. The internationalization of banks has increased and prompted banks to diversify geographically. The development of the deregulation and the technological innovation allowed the majority of financial institutions to capture an increasing part of their flows of income. They accentuated the implementation of diversification strategies through various activities, product lines and banking profession in general.

The diversification has attracted and triggered the interest of researchers (Schmid and Walter, 2012; Goetz et al., 2014). The mechanisms underlying the variation of performance are examined as consequence of diversification strategies in the financial sector (Lee et al., 2014). Berger et al. (2010) show that the divergence results of the anterior researches has been exploited as a source of the empirical investigation.

Sawada (2013) finds that many banks have adopted a strategy of diversification through different activities (commercial banking, insurance, securities underwriting, brokerage, and fiduciary services). Even though, the previous literature has indeed attempted to shed light on the impact of activity diversification on bank performance, the empirical investigations have found polarized results concerning this subject. The analysis of the results of Berger et al. (2010) show that asset

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diversification reduces performance. Although, [Sawada \(2013\)](#) demonstrates that banks' revenue diversification increases the financial performance.

In their research [Deng and Elyasiani \(2008\)](#) and [Cotugno and Stefanelli \(2012\)](#) were interested in the direct and indirect impact of geographic diversification on the performance of banks. Empirically, it has been proven to be difficult to identify the impact of geographic diversification on the performance of financial sector. Moreover, the same difficulty was found to directly measure the economies of scale potential roles and problems of agency in this context ([Goetz et al., 2014](#)).

Several studies analyze the impact of activity and geographic diversification strategies on performance without giving importance to interrelation. However the empirical results related to these subjects are divergent ([Kumar, 2009](#); [Bowen et al., 2014](#); [Mayer et al., 2014](#)). [Denis et al. \(2002\)](#) show a reduction of performance associate with the geographic and industrial diversification of American firms. [Wiersema and Bowen \(2007\)](#), conclude that activity and geographic diversification are substitutes. [Schmid and Walter \(2012\)](#) combine the two diversification strategies of American financial intermediaries and find no significant results. [Bowen et al. \(2014\)](#) examine the nature of their interrelationship (substitute or complementary strategies). Moreover, recent researchers have started to consider how the interaction between activity and geographic diversification strategies may interrelate with firm performance.

The issue diversification-performance is well documented in the corporate finance literature, although a consensus has not been accomplished ([Berger et al., 2010](#)). Our research tries to find a correspondence between the literature on non-financial companies and the financial institutions. Authors such as [Goetz et al. \(2014\)](#) and [Schmid and Walter \(2012\)](#) based their research on banks and financial conglomerates as well as on this literature than on the findings from the field of corporate finance. However, the findings in the corporate finance literature may or may not apply to the financial industry because of the differences between the two industries. Our ultimate objective is to shed light on the lack of the literature on financial institutions and consensus on the impact of activity and geographic diversification on the financial institution's performance. We review more deeply intersecting effects and interactive interfering through the joint impact of the two strategies of diversification which should have a link with performance. [Bobillo et al. \(2010\)](#) suggest that this relationship remains an open-ended issue, which entails the need for its review.

Most of empirical studies on activity and geographic diversification and their interaction was focused on the American market ([Schmid and Walter, 2012](#); [Goetz et al., 2014](#)). A few studies have interested in the European countries ([Baele et al., 2007](#)). The French financial sector did not receive any empirical investigation. Our analysis contributes to the lack of the empirical studies by looking at the activity and geographic diversification and their interaction of French Financial institutions. To our knowledge, this is the first paper that analyses the effect of this relationship on French Financial institutions performance. Based on the statistics published by the Bank of France in 2012, the French financial industry is characterized by 70% of French companies have used bank loans against 30% financed by direct calls to financial markets. This proportion is inverted in the United States. The French financial sector is also considered as the second largest industry of investment funds. In fact it has a financial system representing 10% of the banking system and 5% of the international financial market. It seems be a favorable context to study financial institutions.

Our paper aims at selecting different measures of diversification proposed in the literature. Our contribution consists to explore the effects of dual diversification strategy and their interaction on performance. This is the inevitable result of the multiplication of banking activities whose revenues are not based only on the interest ([Goddard et al., 2008](#)). The measures of activity diversification are carried out according to the types of income: interest income and others. Financial institutions capture an increasing share of their income streams from sources other than those of interest. The increase in these revenues is due to diversification in sectors such as investment banking, venture capital and underwriting insurance, and to the growth of commissions related to traditional banking services. The measures of geographic diversification are in relation to the sales and zones in order to explore its level and intensity.

Our sample adopts a panel of 412 French financial institutions over the period of 2002 to 2012. Our paper contributes to situate this debate at the heart of the financial institutions while focusing mainly on their typologies. Our proposition of the typologies of the financial institutions enables the exploration of the French market, which leads inevitably to the differentiation between the specialized banks and the credit institutions. Furthermore, our contribution essentially at detecting specific diversification effects associated with different classes. The French financial system is characterized by a close links with the insurance companies, asset management companies and banks. This is manifested in particular by cross-shareholdings, which aim at reducing variations between these different types of institutions, [Tadjeddine and Cotta \(2011\)](#). The review of the prior studies shows that each market has its own classifications studied ([Berger et al., 2010](#)). For the French context, these classifications were not exhaustive; therefore we follow the studies of [Berger et al. \(2010\)](#) and [Schmid and Walter \(2012\)](#) in order to develop a specific classification of our sample that could refine our analysis. In our opinion, this is the first paper that develops the classification for French financial institutions, through referring to both the French institutional framework governed by the banking law and to the typology of our database extracted from BankScope.

Finally, our contribution consists in trying to remedy the majority of the methodological limits related to several factors expected to act on the relationship between diversification and performance. We verify the robustness of our results. We test the endogeneity problem. We take into account also an alternative measure of diversification by using the Herfindahl–Hirshman index and a second measure of performance.

The remainder of the paper is organized as follows. In Section 2 we present the related literature of the impact diversification strategies on performance. Section 3 we introduce the French Financial Institutions. Section 4 describes our sources of data, our sample selection process, our variables and methodologies used to measure diversification. The results and

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