



Asymmetric effects of households' financial participation on banking diversification



Pei-Fen Chen^{a,*}, Jhih-Hong Zeng^b

^a Department of International Business Studies, National Chi Nan University, Nantou County, Taiwan, ROC

^b National Sun Yat-sen University, Kaohsiung, Taiwan, ROC

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ABSTRACT

This paper examines banks' diversification–performance nexus from the perspective of demand, the magnitude of households' financial participation, with bank data from 22 European countries over the period from 2002 to 2009. We argue that the magnitude of households' financial participation develops asymmetric diversification effects on banks' performance. The empirical investigation herein provides evidence for the asymmetric influence of households' financial participation on the effect of banks' income diversification on their performance. Our findings suggest that banks should take into account the deposit interest rates and the variety of households' investment habits when they operate toward diversification.

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1. Introduction

Since financial deregulation in the 1980s, many European banks have expanded into non-interest income activities, as evidenced by rather prominent growth in the share of banks' non-interest income within the total operating income of European banks over the last decade. Such raise in share partly is contributed to the increasing competition among banks, for which banks actively expand their non-interest products. Previous studies have probed the effect of diversification on banks' performance, but mixed results remain in these findings (e.g., Landskroner et al., 2005; Mercieca et al., 2007; Sanya and Wolfe, 2011). Recently, some scholars have explored the mixed diversification effects from the perspectives of banks' characteristics, such as their sizes and their risk levels (see Lepetit et al., 2008; Acharya et al., 2006).

This paper discusses banks' diversification effects from the household's demand perspectives, based on both households'

financial investment rates and deposit interest rates.¹ Commercial banks that expand into non-interest generating activities could improve their performances with regard of both returns and risk. Although banks' own characteristics are related to diversification effects from an examination of previous studies, market conditions are correspondingly important to such diversification effects. Many studies have explored the influences of environmental factors (e.g., Stiroh, 2004a; Sanya and Wolfe, 2011), but few have investigated on banks' diversification effects from the characteristics of households' trading behavior. This paper considers cross-sectional and longitudinal factors, including households' financial investment rates and banks' deposit interest rates. Both rates can vary,

¹ Households' financial investment rates are proxied by the ratio of net acquisition of financial assets to net disposable income. If people trade more on non-traditional financial activities with banks, such as buying bonds or mutual funds, remittance, and other fee charges, banks can benefit more from non-interest products or services. On the other hand, changes in deposit interest rates, linked to a monetary policy via the interest rate pass-through effect, also can affect people's wealth and thereby drive them to reallocate their income (e.g., Marx, 1894; Sraffa, 1960; Argitis, 2001; Grigoryan, 2011). Lower deposit rates induce people to transfer their investments from riskless assets to risky assets or portfolios, but higher deposit rates may raise an inverse result. Both rates are associated with people's investing inclination and then their trading frequency with banks.

* Corresponding author at: 4F, No. 470, Dasyue Road, Puli Township, Nantou County 54561, Taiwan, ROC. Tel.: +886 49 2910960x4643; fax: +886 49 2912595.
E-mail address: pfchen@ncnu.edu.tw (P.-F. Chen).

depending from the result of cross-sectional differentials (e.g., investment habits over different countries) or longitudinal cyclical patterns.² The shifts in both rates can be related to trading frequency, meaning the number of times that customers trade with banks, thereby impact banks' diversification performance. To our knowledge, no extant studies consider whether the diversification–performance relationship varies beyond boardlines by taking into account of households' financial participations.

1.1. Households' financial investment rates versus diversification

Households' financial investment rates can directly affect the performances of financial markets (e.g., Hu, 1997; Florackis et al., 2011). Banks that develop non-interest banking products incur additional expenses (e.g., monitoring costs, transaction costs, and other fixed costs). If their marginal benefits do not cover these marginal costs, then banks will suffer losses from their income diversification activities. Hence, a significant scale of trading could possibly raise banks' profits from income diversification. If we proxy households' financial investment rate by the ratio of the acquisition of financial assets to households' disposable income, then households' demand for trading financial assets with banks certainly influences the desire for diversification. Note that trading frequency is also related to risk and volatility. For example, Konishi and Yasuda (2004) find a positive relationship between trading frequency and banks' risk. Xue and Gencay (2012) construct a microstructure model, in which multiple trading frequencies can raise the volatility of returns. Thus, the performance of banks' income diversification can be related to households' financial investment rates.

1.2. Deposit rates versus diversification

Monetary policy can affect economies through the interest rate channel and the credit channel. Previous studies (e.g., Sander and Kleimeier, 2004; De Bondt, 2005; Kleimeier and Sander, 2006) find that monetary policy has a transmission mechanism on retail bank interest rates (e.g., deposit rates, lending rates, etc.). In another phase, the interest rate pass-through effect. As for the effect of monetary policy on deposit interest rates, the economic theory of Marx (1894) presents the linkage between monetary policies and income distribution. Shifts in monetary policies drive households to reallocate their surplus income (e.g., Sraffa, 1960; Argitis, 2001; Grigoryan, 2011). People might transfer their money from risk-free to risky assets, in hope of higher returns, if the original yield rate does not meet their demand. As a result, lower deposit rates are helpful for bank income diversification for inducing higher willingness to participate in financial activities.

Bernanke and Gertler (1995) suggest that monetary policy exerts an effect on credit markets via two channels – the balance sheet and the bank lending channels. The balance sheet channel addresses that changes in monetary policy that impact borrowers' balance sheets and income statements. In addition, higher loan rates increase the cost of new investment projects, and firms, henceforward, leading a greater real value in line until the benefits (costs) of a future new project are guaranteed higher (lower) (see, for example, McDonald and Siegel, 1986). As a result, requests for banking loans drop, and banks thereby have no willingness to expand into new non-interest products due to the result of lower

income. The bank lending channel suggests that changes in monetary policy affect banks' supply of loans. Kashyap and Stein (1995) show that a tighter monetary policy obstructs small banks' lending, but it does not apply to large banks. Kandrak (2012) finds that a tighter monetary policy induces banks to lend to small borrowers unwillingly. With respect to bank income diversification, a tighter monetary policy, accompanied by increasing deposit interest rates, may curtail the performances of non-interest generating activities.

In this paper, we conjecture that the diversification–performance nexus is subject to the conditions of households' financial participation. We further argue that the effects of high and low financial participation scenarios on the diversification–performance nexus are asymmetric. According to our findings, income diversification, conditioned on a low financial investment rate, reduces banks' risk-adjusted returns for both assets and equities. Conversely, banks can benefit more from non-interest products or services when households' financial investment rates are high. However, low deposit interest rates raise banks' insolvency risk, whereas households' financial investment rates do not have statistically significant effects on the risk–diversification relationship. An appropriate level of expanding non-interest products or services indeed improves bank performance, nevertheless, either the differential cross-sectional factors or the shifts in longitudinal (time) can sway the efforts of bank income diversification.

The remainder of the paper is organized as follows. Section 2 reviews the literature. Section 3 exhibits data information, empirical models, and the definitions of our variables. Section 4 offers our empirical analyses and more discussions. The final section is our conclusions.

2. Literature review

A large number of studies have investigated the effect of income diversification on banks' performances (returns or risks), but no consensus seems to be found. For example, Stroh (2004b) explores the relationship between diversification and risk-adjustment performances for small U.S. community banks. He finds that risk-adjustment performances are curtailed by higher non-interest income. Elsas et al. (2010) argue that diversification raises bank profitability. In contrast, Laeven and Levine (2007) show that income diversification harms the market values of financial conglomerates. Lepetit et al. (2008) find that the risk-adjusted performances of small banks in Europe can benefit from non-interest generating activities, although they do not see statistically significant benefits on income diversification for large banks. Banks' own characteristics appear to influence the performance–diversification nexus. Fiordelisi et al. (2011) show that income diversification has a negative effect on cost efficiency and risk. However, few studies investigate the inconsistent performance–diversification nexus standing on the demand side. Hsieh et al. (2013) show that bank stability can be enhanced through income diversification.

Meanwhile, financial participation is related to the concepts of trading frequency, market liquidity, and the habits of market participants. In contrast to the effects of banks' characteristics (supply side), these concepts are associated with the behavior of the demand side. The findings in theoretic and empirical models (Amihud and Mendelson, 1986; Florackis et al., 2011) support that investors' trading costs can fall with increasing trading frequency. Konishi and Yasuda (2004) investigate commercial banks in Japan and find that higher trading frequency can induce higher risk, including overall risk, firm-specific risk, interest rate risk, and downside risk. Xue and Gencay (2012) develop a microstructure

² As suggested in Battiston et al. (2012), the effect of diversification on how the number of defaults in the system depends on the agents' average robustness, the heterogeneity of financial condition across agents, the size of exogenous shocks, and cost of credit runs.

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