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Income Diversification and Financial Performance of Selected Deposit Money Banks in Nigeria

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ABSTRACT

This study examined the effect of income diversification on financial performance of deposit money banks (DMBs) in Nigeria. Variables considered were commission, foreign exchange incomes, and firm age, which are proxies for income diversification and financial performance proxied by Tobin's Q ratio. The purposive sampling technique was used to select the 8 banks classified by Central Bank of Nigeria to be Domestic Systematically Important Banks in Nigeria. Data collected from the annual reports and the Nigerian Stock Exchange website for a period 2008-2018 were used. Statistical tools used were the descriptive statistics and econometric analysis using the panel data. Findings showed that while commission income has a significant positive effect on Tobin's Q ratio of DMBs, foreign exchange income and firm age each have a significant negative effect on Tobin's Q ratio of DMBs in Nigeria. It is recommended that banks in Nigeria minimize their income from foreign exchange to maximize performance since income from these transactions tend to inhibit bank financial performance.

KEYWORDS

Banks, Commission, Financial Performance, Income Diversification, Tobin's Q Ratio

1. INTRODUCTION

Commercial banking has remained an essential business which has contributed to the growth of economic activities around the world. The banking sector forms one of the pillars of economic development in the world through the mopping up of funds and other resources from the surplus segment of the economy and making them available to the deficit segment in return for interest income, thus, stimulating and promoting investments, economic growth and ensuring even developmental spread (Nzotta & Okereke, 2009). Interest income from banks' intermediation activities remains banks' core income source and has been a major contributor to banks' earnings from traditional financial services prior to digital banking. A country like Nigeria with an emerging economy and

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banking sector has witnessed a tremendous growth in size, technology and competition as a result of the reforms in the Nigerian banking sector.

The banking sector across the globe plays a major role in the business of financial intermediation and has grown over the years, resulting in the diversity and complexity of its operations. Following this development, deposit money banks (DMBs) have advanced from what used to be their core line of business, which is, mobilizing deposits and advancing loans, to other financial noninterest earning intermediation services such as derivative arrangements, provision of financial guarantees, investments, foreign exchange transactions, among others. The growth of non-intermediation income activities suggests intermediation activities are becoming less important part of banking business strategies and strategically, banks have shifted their sales mix by diversifying into other income sources. These activities which are widespread in developed countries have been widely debated and reported in the academic literature (Feldman & Schmidt 1999). The adoption of universal banking principle has made DMBs to compete on a wider range of market segments such as investment banking and market trading (Lepetit, Nys, Rous, & Tarazi, 2008). According to Goddard (2004), banks are now able to participate in what were previously regarded as inaccessible domestic and foreign markets. This financial noninterest earning intermediation services have necessitated DMBs to naturally increase diversification by moving into fee-based activities whilst banks with already strong fee-based revenues expanded into trading activities (Elsas, Hackethal, & Holzhäuser, 2010). DMBs generate increased portion of their income from non-intermediation activities (DeYoung & Rice, 2004) and this could be linked to financial liberalization policies.

According to Stiroh (2004), most European banks have widened their product offerings to become universal banks in the 1990s. Stiroh (2006) positively affirmed that wider revenue stream diversifies the banking industry, thus, increasing financial performance and promoting economic stability. Nevertheless, majority of those in the banking business had continued to underestimate, relegate, or misunderstood how increased noninterest income has affected the financial performance of banking companies (DeYoung & Rice (2004). The Nigerian banking sector being an evolving one is not exempted from the evolution in the banking sector, thus the need to consider developments as it pertain to noninterest income activity in an emerging banking sector in Nigeria, relative to the realities in developed world. According to DeYoung and Rice (2004), the increasing presence of noninterest income at commercial banks has been widely documented and discussed in the industry press and regulatory publications but only a few academic studies have investigated the effect of banks' diversification (increased noninterest income) on the financial performance of DMBs in Nigeria.

The Nigerian financial sector and the banking industry have undergone series of reforms that brought changes not only in the number of banks and financial institutions but also in the diversity of products and services they render. According to DeYoung and Rice (2004), banks are increasingly exploiting nontraditional avenues of generating income, to the extent that in recent times, almost half of banks' incomes in the US are obtained from nontraditional activities and this reflects not only a diversification of banks into nontraditional activities, but also a shift in the way banks earn money. The conventional wisdom in the banking industry is that earnings from noninterest products are more stable than loan-based earnings, and that noninterest activities reduce bank risk via diversification (Nisar, Peng, Wang, & Ashraf, 2018).

This paper is divided into five sections. Section one discusses the introduction, following the introduction is section two which focuses on literature review and hypotheses development with emphasis on: conceptual review, theoretical review and review of empirical studies. Section three harps on the methodology. This is followed by section four which focuses on the estimation results and discussion of findings, and finally, section five presents the conclusion and recommendations.