Chapter 7

SUMMARY FINDINGS AND CONCLUSION

A summary of the main findings of the study conducted on the topic “Diversification in Banking Sector in India -Determinants and Effect on Financial Performance” is presented in this chapter. Further it is followed by some reflections about scope of further research. A bird’s eye view is given in summarized form to the purpose of the study, reviewed literature, research methodology and scope of different chapters.

Contemporary developments and changes in banking laws and regulations have forced commercial banks to diversify their product and services into new product lines and geographical areas. Banks adopt diversification move as a part of their growth strategy. The term “Diversification” is characterized by the concept of multi-dimensionality and growth. As per Ansoff (1957) diversification refers to “entering new market with new products”. According to Rumelt (1974) diversification strategy is ‘a firms commitment to diversity per se, together with the strengths, skills or purpose that span this diversity, shown by the way in which business activities are related to one another.

In the academic literature, the concept of diversification has been studied largely in context to corporate sector. Empirical studies on diversification in banking sector in case of developing economies are lacking. In the banking literature, a complex picture emerges out from the studies on diversification and performance across both geographic and product diversification. Some studies favour the pronouncement of diversification in banks like Hitt et al., 1997; Hennart and Park, 1994; Geringer et al., 2000 etc. Vander Vennet (2002) shows that diversified bank are more revenue efficient than their specialized competitors. The results of the study indicates that the current trend toward further de-specialization may lead to a more
efficient banking system. Boyd et al., (1993) used hypothetical cross-product mergers and simulations and found risk reduction effects from these deals. Estrella (2001) examined direct measures of potential diversification gains from consolidation of financial firms. While some studies found negative impact of diversification on banking activities. (Rumelt, 1974; Berry, 1975; Geringer et al., 1989; Hitt et al., 1997; Palich et al., 2000). While some studies found inconclusive and contradictory results (Rumelt, 1982; Montgomery, 1985; Michel and Shaked, 1984; Grant et al., 1988).

7.1 Introduction

The banking system in India, being the dominant segment accounts for over 80% of the funds flowing through the financial sector. A substantial transformation have taken place in banks in terms of increased competition, new technological innovations, changing customer preference, diverse products and services, dynamic and flexible financial instruments, increased disintermediation etc. The intent of this thesis is to provide empirical evidence on the different aspects of diversification of banks in India such as nature and extent of diversification, determinants of diversification and its impact on financial performance of Indian banks.

In the introductory chapter, concept of diversification is defined along with its benefits and associated costs are discussed theoretically. Rationale behind adopting diversification in banking sector in India and at global level along with possible cost of diversification is reviewed briefly. Diversification models and strategies applied in banking sector is explained with the help of figures. Herring and Santomero (1990) proposed a theoretical model to evaluate the alternative corporate structures of financial conglomerates. They distinguished between four basic models for organizing a financial conglomerate, based on the degree of legal and operational separateness. The alternatives range from the German model, with complete integration, to a holding company with no operational relationships with its
subsidiaries. The study consists of seven chapters, in which following three objectives are studied:-

1) To study the nature and extent of diversification in Indian banking sector.
2) To examine the determinants of diversification in banks in India.
3) To analyze the effect of diversification on financial performance of banks

7.2 Review of Relevant Literature

There is apparently dearth of studies on diversification in banking sector in India, if not non-existing. So reference to empirical and theoretical studies related to this aspect conducted in and abroad, are reviewed to have a general overview of studies which investigated the nature and extent of diversification in financial sector, determinants for diversification and its relationship with financial performance.

In various contemporary studies, (Gort, 1962; Rumelt, 1974, 1982; Montgomery, 1979, 1982; Nathanson and Cassano, 1982; Pitts and Hopkins, 1982; Palepu, 1985; Varadarajan and Ramanujam, 1987 have studied nature and extent of diversification in financial firms and banks). Amit and Livnat (1988) examined two types of diversification strategies, related and unrelated. According to the authors the related diversification has more in common with operating synergies, whereas the unrelated seems to have more in common with the search for financial benefits due to greater stability in cash flows), attempt is made to reflect the extent of firm diversity and relatedness among the various businesses of diversified firms. Gort (1962) argued that the prospective return on investment is a function of growth and that firms in slow-growing sectors should be expected to diversify into faster-growing sectors. Rumelt (1974) in his study categorized types of diversification along strategic lines: single product strategies; diversification strategies with most economic activity in a dominant industry; diversification strategies that focused on related markets; and strategies that concentrate on unrelated product markets. Markides and Williamson’s (1996) concluded that assets are important for successful diversification as per the resource view
of diversification. Hitt et al., (1997) argued that the theoretical explanation that the firms built up their capabilities in product expansion and geographic expansion being complementary strategies as well as develop an appropriate organizational structure and better governance. Shull and White (1998) presented an analysis of three alternative organizational structures namely the universal bank model, the holding company affiliate and the operating subsidiary. Verweire and Berghe (2001) studied different dimensions viz, degree of diversification, mode of diversification and link between diversification and performance and concluded that a combination of the internal development route and actively pursuing the synergies between the different banking and insurance activities results in better performance. Klein and Lien (2009) examined the situation in which firms determine the optimal boundary for diversification of the firm across different industries and found that, firms prefer to diversify, in situations, when firms have valuable and difficult-to-imitate resources and such resources are complementary to resources in other industries.

In the second part of study, various studies have been reviewed, which reflect, many possible motives behind diversification strategies (Amit & Livnat, 1988; Grant 1998; Jung, 2003; McCutcheon, 1991; Wood & Batiz Lazo, 2001; Montgomery, 1994; Scherer, 1980; Sambharya, 2000). Silverman, Murray, Castaldi and Richard (1992) studied the environmental and organizational factors like CEO’s perceptions of competitive intensity, change in customer preferences for financial services, bank size and past earnings etc. which influence the small bank’s propensity to diversify. Montgomery (1994) provided three perspectives on diversification, the market power view, the resource view and the agency view. Jixin XU (1996) highlighted two main motives of portfolio diversification namely, higher external returns and portfolio diversification to reduce risk. Vennet’s (1997) studied on the determinants of European bank mergers shows that the majority of the operations implemented are in-market M&As aimed at increasing bank market power. The evidence relative to the diversification activity of European banks seems to support the idea that, at least in part, the increase in market power has implied an improvement in the generation of
new business. Milbourn, Boot and Thakur (1999) presented a model to in banks’ managers take decision to enhance their reputation despite the dissipation for stockholder’s wealth. Second, managers think that the strategies increasing size and scope of operation may increase shareholder wealth. Landi and Venturelli (2002) highlighted the external and internal factors such as economies of scale and scope, declining interest margins, cost control, etc. are forcing banks to diversify. Went and Peter (2003) given the arguments for the diversification as improving competitive position, broadening functional competencies, changes in legislative and regulatory environment besides complementing branch networks and competencies. Mallick (2008) analyzed comparative advantage of adopting strategic specialization or diversification in banking operations and found that in wholesale and corporate banking, domestic banks have comparative advantage as compared to foreign banks.

In the third part of review of literature, various studies on the diversification and performance have been reviewed (Christensen & Montgomery, 1981; Delois & Beamish, 1999; Diamond, 1984; Boyd and Graham, 1986; Lubatkin & Rogers, 1989; Rumelt, 1974, 1982). Caves et al., (1980) and Lecraw (1984) found that large firms that were classified as unrelated diversifiers and that were heavily engaged in merger activity, tended to report lower profits over the period 1960-1975 than did less diversified firms. Boyd et al., (1993) used hypothetical cross-product mergers and simulations and found risk reduction effects from these deals. Boyd and Graham (1988) found that life insurance companies seem to offer good prospects as matches for bank-holding companies because of potential diversification gains. Wall et al., (1993) reported a negative correlation between the ROA of commercial banks and securities brokers, which indicates that the combination of those activities can result in a reduction of the global company risk. Saunders and Walter (1994) compared the competitiveness of financial institutions, which operate in different regulatory environments. It was concluded that the elimination of restrictions on the scope of activities allowed the competitiveness of financial services companies on the long run in periods of increasing international competition. Kwan (1998) found that
companies, active as pure traders realized a higher ROA (return on assets), while the ROA of companies active in placing securities is comparable to those of commercial banks. Generale and Gobbi (1999) showed that the most efficient banks in developed countries earn a smaller percentage of their profits from traditional activities and a larger share from off-balance-sheet operations (like life insurance and mutual fund sales). Kwan and Laderman (1999) investigated the relative profitability of hypothetical combinations of banks and other financial intermediaries. The authors concluded that especially insurance and stockbroking and to a lesser extent underwriting and investment banking, contribute positively to the profitability of integrated service providers. Vander Vennet (2000) analyzed the difference in cost and profit efficiency between European financial conglomerates and specialized banks based on a stochastic frontier. It was found that for an output mix of traditional (deposits and credits) and non-traditional bank activities (provisions, stockbroking, etc.) financial conglomerates are more revenue efficient than their more specialized competitors, although the differences are small. Estrella (2001) examined direct measures of potential diversification gains from consolidation of financial firms and the results indicates that there may be bilateral diversification gains from mergers involving the banking and insurance industries. Kist (2001) pointed out that the premise for creating such conglomerates is to create value for all stakeholders, i.e. shareholders, employees and most important, their clients. An integrated financial services company (IFS) is defined as an organization that provides insurance, banking and asset management products to its customers through a variety of distribution channels. Being a conglomerate increases the number of opportunities to diversify. Vander Vennet (2002) found that financial conglomerates are more revenue efficient than their specialized competitors. Gallo et al., (2003); Smith et al., (2003) and Allen and Jagtiani (2000) found the diversification benefits at the individual bank level as well as at systemic level. Aviat and Coeurdacier (2007) found a strong and positive correlation between banks’ international asset holdings and international trade. In addition, diversification creates competitive pressures amongst banks competing on a

7.3 Research Methodology

The following research methodology has been used to achieve the objectives of the study.

The Research Framework Scheme

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( refer to table 3.1, chapter IIIrd)
Need of the study

The purpose of this thesis is to provide insights into the different aspects of diversification in banking sector in India. Due to de-regulation and liberalization, there has been a lot of policy changes that might affect diversification and other expansion strategies of banking business. Moreover, the disintermediation in commercial banking in combination with new capital adequacy rules has put an increased pressure on the banks profitability. Therefore, banks have had to diversify and look for other sources of profits, preferably without increasing their necessary solvency level. This brings to the need and subject of this study. An attempt is made to investigate the impact of diversification on financial performance of banks in India, besides studying the nature and extent of diversification and determinants of diversification in banking sector in India.

Another reason for the study is that as most of the empirical literature which has been reviewed has concentrated on corporate diversification and focused mostly on developed countries. The concept of diversification in financial service industry, particularly with respect to banking sector, is of recent origin in developing countries like India. Therefore, there is a need to study the implication of diversification in banks in India.

Sample Description and Period of study

The present study is focused on Indian banking sector only and analysis is restricted to the scheduled commercial public and private sector banks in India excluding foreign sector and regional rural sector banks. In order to study the nature and extent of diversification, it is required to differentiate between diversified banks from non-diversified banks. Those banks are included in the definition of diversified banks, which have atleast one insurance subsidiary or investment institution or both. These may be in the form of a subsidiary, joint venture or in any other mode such as alliance distribution etc. For the purpose of analysis, diversified banks are compared
with non-diversified banks. The study has been conducted for the time period of 15 years from 1994 to 2008.

**Database**

For the purpose of study, both primary and secondary data has been used. Primary data required to serve the objectives of this research study is collected by means of a questionnaire, specifically developed for the purpose. A total of one hundred and twenty questionnaires were got filled from area managers, zonal managers and branch managers of different diversified banks. Out of these one hundred and twenty questionnaires, one hundred questionnaires completed in all aspects were finally selected for the purpose of analysis. Secondary data is collected from several sources, which include database provided by Reserve Bank of India, Indian Bankers Association, Prowess and Capitaline database.

**Statistical technique**

Techniques used for the purpose of studying the specified objectives are: Entropy measure (used to measure the extent of diversification in banks), Factor analysis (used to study the perceived relatedness in diversified banks and various determinants of diversification), Ratio analyses (to study the relationship of various variables), Coefficient of Variation (to measure volatility of returns) and Regression analysis (to study the impact of diversification on financial performance of diversified banks).

**Hypothesis of the Study**

In order to study the third objective of the study that is to investigate the difference in the performance of diversified banks and non-diversified banks, the following three hypotheses are set:
Ho: There is no difference between financial performance of diversified banks and non-diversified banks.

H\(_1\)o: Degree of diversification has no significant impact on total income of diversified banks.

H\(_2\)o: Degree of diversification has no significant impact on non-interest income of diversified banks.

7.4 Structure of the study

Chapter one is introductory in nature. The term diversification, diversification strategies and various diversification models have been discussed in detail.

The second chapter details out review of literature related with the study and grouped into three categories according to the objectives of the study.

Research methodology applied for studying the set objectives is discussed in third chapter.

In chapter four, first objective of the study is analyzed that is to study the nature and extent of diversification in banking sector in India.

Chapter five analyzes the various determinants of diversification in banks in India.

Chapter six focuses on the empirical analysis of impact of diversification on financial performance of banks.

Major findings and summary of the study is given in seventh chapter with scope for further research.
7.5 Findings of the Study

• Nature and Extent of Diversification in Indian Banks.

Nature and Extent of Diversification in Indian Banks is studied in three parts. In the first part, nature of diversification is studied. For this purpose, methodology used by Ramanujam and Varadarajan (1987) is applied. Firstly, banks are identified whether they are diversified or not. Further diversified banks are categorized into three categories depending upon the nature of their diversification i.e., BSD (Broad Spectrum Diversification-Unrelated Diversification), NSD (Narrow Spectrum Diversification-Related Diversification) and AD (Alliance Diversification). Major findings in this aspect are summarized below.

• Nature of diversification in Indian banking sector

1 In respect of public sector banks in India, out of a total of 21 banks, 12 banks are diversified and 9 banks are non-diversified as on 31st March 2008.

2 State Bank of India and Bank of Baroda have adopted both BSD (Broad spectrum diversification) move and NSD (Narrow spectrum diversification) move along with AD (Alliance diversification).

3 All other public banks which are diversified, like Canara bank, Union Bank of India, Corporation bank etc. have adopted only BSD and AD mode.

4 In case of Private sector banks, old private sector banks are not diversified at all.

5 Most of the new generation private sector banks are highly diversified. HDFC Bank, ICICI Bank, Indusind Bank, Kotak Mahindra Bank, AXIS bank and ING Vysya Bank are categorized as banks that have followed BSD (Broad spectrum Diversification) and AD (Alliance Diversification) to expand their banking and non banking products and services.
In the next part of this chapter, degree of diversification is measured. Entropy technique, Jacqueimin and Berry (1979), is applied to calculate diversification index of diversified nationalized banks, SBI and group and private banks.

- **Degree Of Diversification**

On the basis of entropy index of diversification (Jacqueimin and Berry (1979)), overall diversification level is the highest in SBI group followed by private sector banks and least is in case of nationalized banks except in the year of 2007 and 2008. A mixed trend is found in nationalized banks while in private banks, mixed trend is seen till year 2002 and after that it is continuously increasing and is the highest in the year 2007 and 2008.

In the third part of fourth chapter, type of relatedness in diversified banks is examined through factor analytical technique.

Six types of relatedness are found as follows.

- **Financial Relatedness factor ranked** as first important factor of relatedness, perceived in diversified banks and include variables V01 “Businesses are required to meet financial targets” and V04 “Businesses emphasize on low costs strategy”.

- **Marketing Relatedness factor** ranked second important factor of relatedness in diversified banks. It consists of variables namely, V10 “Businesses emphasize on marketing”, V20 “Businesses have about the same market share”, V03 “Business share distribution network” and V21 “Businesses serve niche markets”.

- **Service Relatedness factor** ranked as third important factor of relatedness in diversified banks. It include five variables namely, V06 “Businesses emphasize product development”, V07 “Businesses produce high value-added services”, V08 “Businesses share back office”, and V05 “Banks are similarly
impacted by economy” and V22 “Businesses pay attention to service”.

- **Size Relatedness factor** is ranked as fourth important type of relatedness in diversified banks and include variable V19 “Businesses are about the same size” and V02 “Businesses share customers”.

- **Technology Relatedness factor** encompasses variables V09 “Businesses emphasize R&D”, V13 “Businesses have strong brand names”, V14 “Businesses share technology” and V018 “Businesses share common core business” and ranked as fifth important factor of relatedness perceived by diversified banks.

- **Managerial Relatedness factor** is encompassed of items which are of strategic importance and ranked as sixth important factor. It consist of five variables namely V11 “Businesses share management information system (M.I.S.)”, V12 “Businesses require the same management skills”, V15 “Businesses share corporate culture”, V16 “Businesses aim at the same corporate goals” and V17 “Businesses use the same strategic concepts” to run the business.

- **Determinants (Motives) of Diversification**

  Chapter fifth is aimed to study the factors that have driven banks in India to adopting diversification. These factors which are extracted from review of various studies are categorized into two categories viz, external determinants and internal determinants.

  - In external determinants, significance of factors that are macro in nature are discussed theoretically. Following determinants are discussed.

    - Regulations, laws and economic conditions, which include financial liberalization and removal of constraint
- Globalization phenomena and to harmonize with international standards (for example, Basel I & Basel II) and others are related to the circumstances in the banking industry itself (for example, the degree of concentration and excess energy).

- Dynamics of bank competition

- Technological progress

- Disintermediation in banks

- To analyze the internal determinants, factor analytical technique has been used. In the category of Internal Determinants for diversification, eight motives emerged out as significant in banks decision to diversify.

- The “Financial Motive” has ranked as the first important factor in banks decision to diversify and includes variables V501 (to access new source of deposits), V508 (to Increase earning per share) and V5019 (to supplement revenue).

- The “Growth Motive” has ranked as second important factor in making banks to diversify their operation and services and consists of variables V5010 (To increase profitability) and V509 (To increase growth).

- The “Customer Retention Motive” has ranked as third important factor and groups five variables, V5017 (to Retain existing customers), V5013 (to Obtain new loan customers), V505 (to broaden customer base), V507 (to expand sales to existing customers) and V5024 (to meet changing customer perception).

- The “Risk Reduction Motive” has perceived as fourth important factor in the banks decision to diversify and encompasses of three variables V5018 (To reduce risk by operating in a number of different areas), V504 (to escape the systematic risk of a single market) and V502 (to acquire new marketing capabilities).
The “Cost Management Motive” ranked as fifth important factor and groups three variables namely V5021 (To gain market power), V5015 (to reduce cost) and V5022 (to reduce monitoring cost).

The “Competition Motive” includes variables V5023 (To meet diversification moves of domestic competitors), V5014 (To position the bank to be competitive in the future) and V5011 (To increase shareholder’s wealth). It is ranked as sixth important factor in banks decision to diversify.

The “Optimal use of Technology Motive” perceived as seventh important factor and encompassed of variables V5012 (To keep technology up-to-date) and V5016 (To respond to internet services of competitors).

“Realizing Economies Motive” ranked as eighth important factor and includes variables V5020 (to gain Economies of scale and Economies of scope), V503 (to apply corporate management skills to new businesses) and V506 (to save cost from integrating particular activities).

Impact Of Diversification On Financial Performance

In chapter six, attempt is made to investigate the difference in the performance of diversified banks and non-diversified banks. For this purpose, various hypotheses are set to examine the performance consequence of diversification in banks. Secondary data is used for the purpose and simple regression analysis technique is used.

Findings:-

Ho: There is no difference between financial performance of diversified and non-diversified banks. Hypothesis is not accepted because:

It is found that the level of interest income to total assets is continuously declining in respect of diversified banks and it fell to 7.72 in 2008 from 9.94 in 1999. In case of non-diversified banks, a fluctuating trend is seen. Coefficient of
variation for level of net interest income to total assets lies between 22.40% to 39.06% for diversified banks and 06.96% to 24.78% for non-diversified banks, which shows that variation of net interest income to total assets, is less for diversified banks as compared to non-diversified banks

- **An increasing trend is observed in ratio of non-interest income to total assets in case of diversified banks** except in the year 2005. While large variations are found in case of non-diversified banks during the same duration. Coefficient of variation for ratio of non-interest income to total assets lies between 32.99% to 50.62% in respect of diversified banks and 27.56% to 60.61% in case of non-diversified banks, which shows that variation in non-interest income to assets, is more in non-diversified banks as compared to diversified bank.

- COV is higher in case of non-interest income to asset i.e., 17.97% in case of diversified banks and 33.28% in case of non-diversified banks as compared to interest income to assets, which shows that non-interest income is more volatile.

- On the basis of **ROA, profitability of diversified banks** is found to be better as compared to non-diversified banks. In case of return on assets diversified banks outperformed specialized banks except in the year 2000 and 2002. ROA of diversified banks is 0.7 percent in 1999 and it arose to 0.91 percent in 2008, while in case of non-diversified banks it was 0.64 percent and declined to 0.39 percent in 2008.

\[ H_{10}: \text{Degree of diversification has no significant impact on total Income of diversified banks.} \]

- Hypothesis was not accepted. A positive impact of degree of diversification on total income of all the three banking group is found. But in case of SBI group and private banks, significant influence of degree of diversification is observed, as shown by ‘t’ test value i.e., 3.132 of private banks and 2.868 of SBI group at 5
percent level of significance while it is marginal in respect of nationalised banks as ‘t’ value is 1.38.

**H$_{20}$:** Degree of diversification has no significant impact on total Income of diversified banks.

- This hypothesis was not accepted as degree of diversification does have impact on non-interest income of all banks. In case of private banks and SBI group, substantial influence is observed. As growth in non-interest income attributable to degree of diversification is found highest in private sector i.e., 49.52% followed by SBI group i.e., is 40.8 %. However, a marginal impact is found in nationalised banks, as just 20.3% growth in non-interest income is attributable to degree of diversification.

### 7.6 Conclusion

The emergence of diversification in finance sector as a global phenomenon has given rise to a new scope of competition for the banking sector. Majority of the banks in India have adopted Broad Spectrum Diversification for diversifying their operations that is diversifying through non-banking subsidiaries and alliances, joint ventures etc. Decision to diversify is affected by both internal and external factors. Determinants like financial motive, growth motive, customer relationship motive, risk reduction motive, cost management motive, competition motive, optimum use of technology and economies in operation motive have been instrumental in banks decision to diversify. The performance of diversified banks is found to be better as compared to non-diversified banks. In diversified banks, non-interest income has increased in importance relative to net interest income, as continuously increasing trend is seen. A positive and significant impact of degree of diversification (entropy index) on non-interest income and total income of State bank of India group and private banking sector is found. In respect of nationalized banks, a positive but marginal impact of degree of diversification on non-interest income and
total income of banks is found. Comparatively, volatility of returns is found higher in respect of non-diversified banks, which shows that diversified banks have stable pattern of earning.

To sum up, it is found that diversified banks are significantly better as compared to non-diversified banks and degree of diversification has positive impact on financial performance of diversified banks

### 7.7 Scope for Further Research

The present research is directed to study the insights into the different aspects of diversification in banking sector in India namely nature and extent of diversification, determinants of diversification and to find impact of diversification on financial performance. The results of this study provide a substantial avenues for further research on the subject.

One relevant area for further research could be to investigate cross-border diversification. As this study is focused on diversification in banking sector in India only. But it would be interesting to replicate this study on geographic diversification and cross border diversification in banking sector. Such type of study can focus on analyzing benefits and cost attached with cross-border diversification. Further, a cross-country comparison of performance consequence of diversification in banks could be analyzed.

A second and perhaps even more interesting issue could be to investigate diversification strategies and mode adopted for diversification by various banks. The parameters of diversification mode and implications of different strategies could be characterized and examined in detail.

Another study can be done on the relatedness aspect of diversification. The rationale of related-diversification and efficiency gain realized could be analyzed empirically.
Diversification concept in banking sector has a contributory role in emergence of large banks as financial conglomerates. It has resulted in supervision and regulation problems, which necessitates merging of the respective supervisory and regulatory authorities. So, implications for diversification and convergence of supervision and regulatory authorities could also be analyzed.