Chapter 1

INTRODUCTION

Diversification in financial institutions has emerged as a global phenomenon with the growing convergence between different segments of finance sector namely banking, insurance and investment. In finance, diversification refers to a portfolio strategy designed to reduce exposure to risk by combining a variety of investments, which are unlikely to move in the same direction (Anne-Gaelle, 2004). It is the process of introducing variety. According to business dictionary, diversification can be a growth strategy, aimed at reducing risk by spreading interests over different areas¹.

Breaking down of the barriers between the different segments of the financial service industry is one of the most remarkable trend which has emerged in the beginning of the eighties. In countries where the boundaries between the different sub-sectors have broken down, the majority of the banks and the insurance companies have engaged in cross-selling each other’s products (Berghe et al., 1999). Commercial banks now days have become quite diversified and non-traditional. This is because the banking industry, the world over, has undergone drastic change in the wake of deregulation, liberalization, disintermediation, competition, squeezed interest margins and automation. On the demand side, the customer of today has become more conscious and expects sophisticated, customized services. In response to these changes, banks have attempted to adopt diversification strategies to improve efficiency, increase output and expand the range of services offered (Goddard et al., 2001). Banks' intermediation activities came under pressure due to phenomena such as securitization, the development of liquid capital markets followed by the access for larger companies to cheaper non-banking financing and the growth of financial derivatives (Vennet et al., 2007). As a consequence, disintermediation in banking activities resulted in lower profitability and squeezed interest margins. Banks were thus pressurized to diversify and look for new sources of

non-traditional revenues like insurance, investment and other non-traditional banking services. Mergers, amalgamations, acquisitions and consolidations on a large scale have also led to emergence of banks as financial conglomerates. As a result, the banks these days have separate subsidiaries for a wide range of financial services such as leasing, mortgage, financial engineering, insurance brokerage and consulting services (Berghe, Verwiere and Carchon, 1999).

1.1 Diversification – The Global Phenomenon

The increasing importance of both non-traditional banking businesses and product brokerage at commercial banks is a global phenomenon. Especially, in countries where banks have become conspicuously larger as a result of the system-wide financial sector restructuring as in Asia and the high level of consolidation through voluntary mergers and acquisitions among banking groups as in Europe (Lepetit et al., 2004). The Second Banking Directive of the European Union EU (1989) allows the formation of financial conglomerates and universal banks. In this directive, the EU chose for a broad definition of "credit institution", in line with the definition of the German universal banks. Banks, insurance companies and investment firms are thus allowed to participate fully in each other’s share capital. There are no longer any legal restrictions on the formation of financial conglomerates and universal banks. Earlier in the US, the Great Depression led to a strict separation between commercial banks, investment banks and insurance companies (the Glass-Steagall Act, 1933). However, to modernize the US financial sector the regulators introduced the Financial Services Modernization Act (also known as the Gramm-Leach-Bliley Act, 1999), which allows combinations of commercial and investment banks. At the same time, the restrictions imposed by the Bank Holding Company Act (1956), were abolished. The International Monetary Fund (IMF) has also noted the trend towards consolidation of banks with non-bank financial activities and the emergence of universal banks in the nature of financial conglomerates (Milo, 2007).

As in other economies of the world, universal banking in India is gaining attention with the changed income structure, customer preferences and high-tech infrastructure. In India, financial market reforms initiated in the early 1990s, focused on removal of
structural bottlenecks, introduction of new players/instruments, free pricing of financial assets, relaxation of quantitative restrictions, improvement in trading, clearing and settlement practices and greater transparency (Mohan, 2004). As a result of these reforms, banks have started adopting diversified and universal banking structures in different forms and degrees. For example, three Indian universal banks SBI, HDFC and ICICI banks have made inroads in asset size, business volume and product diversification etc. In short, today, these entities have all become diversified one-stop financial supermarket.

1.2 Diversification- The Concept and the Definition

Diversification in corporate sector has been a center of major attention in the history of strategic management research. The work of Gort and Chandler is regarded as the starting point for numerous contributions on the topic of diversification (Chandler, 1962; Gort, 1962). Numerous contributions from the fields of industrial economics, finance and organizational sciences or strategic management have analyzed the phenomenon of diversification from a wide variety of view points (Dautwiz, 2009).

Diversification is a means by which a firm expands from its core business into other product markets (Aaker, 1980; Andrews, 1980; Berry, 1975; Chandler, 1962). Ansoff (1957) was pioneer in discussing the diversification strategy as ‘an act of entering new market’. In strategic management literature, Ansoff (1965) considered diversification as a growth strategy by which a company tries to serve new markets with new products. Diversification strategy is given in a Growth Vector Matrix (Fig. 1.1) which is indicative of the simultaneous departure from present product lines and present product mission and market. A product mission refers to defining the market boundaries for a product and product line. Other strategies in the matrix are ‘market penetration’, ‘market development’ and ‘product development’. Market penetration refers to increasing existing product market share in existing markets. Market development involves the identification of new customers for existing products and product development includes developing new products for existing customers.
The theoretical justification for growth through diversification is outlined by (Penrose, 1959) who believed that companies with narrow product offerings i.e. the single business and dominant business companies were constrained in their profit potential by market growth limitations and because of their dependence on a limited range of products/services were vulnerable to changes in demand and competition. Chandler (1962), Gort (1962) and Rumelt (1974) are other named academicians along with numerous others who have contributed significantly to the literature and published their research efforts with respect to diversification.

Chandler (1962) discovered several stages in the process of development of diversification strategy.

• At first stage, firm starts with a single product business serving demand of local market;
• At second stage, improved transport and communication facilitates the firm expansion from a local market to a regional and a national market;
• At next stage, firm begins to expand further by vertical integration, either backwards (acquiring supplying firms) or forward (into marketing and distribution system);
• At next level, excess marketing capacity and distribution system causes firm to diversify their product range and geographical areas.

Gort (1962) defined diversification as an increase in the ‘heterogeneity of output’ as indicated by the number of separate markets a firm serves.
Rumelt (1974) worked out an alternate way to define diversification strategy. The author has given the definition of diversification strategy as ‘a firm’s 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’.

According to Kamien & Schwartz (1975), ‘diversification is the extent to which firms classified in one industry produce goods classified in another’.

While other authors Penrose (1959); Galbraith (1983); Werner Felt (1984); Montogomery (1994) conceptualized strategic view of diversification and suggest that the extent of diversification is a function of a firm’s resources.

Booz, Allen and Hamilton (1985) have defined diversification as ‘a means of spreading the base of a business’.

Ramanujam and Varadarajan (1989) have defined diversity as ‘the extent to which firms are simultaneously active in many different businesses’.

The “diversification” concept is an integral part of strategic management, which is nowadays administered in financial services sector too. Harry Markowitz first presented the concept of “diversification” in finance, also known as Modern Portfolio Theory (MPT) in 1952. The portfolio theory aims to reduce risk by spreading the investments into a variety of securities and consists basically of two main components, the systematic risk, i.e. the market risk and the unsystematic risk, i.e. the individual security risk (Eiteman, Stonehill & Moffett, 2004).

The term ‘diversification’ in banking sector has originated from the concept of universal banking, denoting ‘the entry of a firm or a business unit into new lines of activity, either by processes of internal business development or acquisition, which entail changes in its administrative structure, systems and other management processes’ (Ramanujam and Varadarajan, 1989).
Therefore, diversification is defined in the broadest terms as the involvement of an existing business entity into new business either through the way of internal development or through outward expansion. As such, diversification can be seen as one alternative to achieve a growth strategy.

1.3 Diversification in Indian Banking Sector

Liberalization, privatization and globalization of Indian economy in 1991 provided an impetus to consolidation and convergence in India (Sharma, 2004). The committee under the chairmanship of M.Narshiman laid down the foundation of banking sector reforms in 1991, which entailed several proposals relating to the structure, organization, functions and procedures of financial system. The thrust of these reforms was to promote a diversified, efficient and competitive financial system with the ultimate objective of improving the efficiency of resources, through operational flexibility, improved financial viability and institutional strengthening (Reddy, 2006).

The Indian banking system has been the subject of continuous liberalization to varying degrees since 1991, it remained tightly regulated by international standards with special reference to CAMELS (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Systems & Controls) standard. To review the functioning of banking system in India, various review committees (Table 1.1) have been set-up by Reserve Bank of India. These committees have given various recommendations which have induced greater competition with enhanced application of information technology, customized skills, greater portfolio diversification and better risk management practices. After the implementation of reforms and freeing from regulatory clutches, banks have improved significantly over the last decade. It is generally thought that the entry of well-capitalized new banks is likely to improve the quality and variety of services, efficiency of bank management and prudential supervisory capacity (Levine, 1996; Walter and Gray, 1983).
Table 1.1: A Brief Review of the Committees set-up by Reserve Bank of India.

<table>
<thead>
<tr>
<th>Year</th>
<th>Name of the Committee</th>
<th>Objective</th>
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<tbody>
<tr>
<td>1982</td>
<td>Sukhmoy Chakraborty</td>
<td>Improving Monetary System in India.</td>
</tr>
<tr>
<td>1991</td>
<td>S. Narasimham</td>
<td>Financial Sector Reforms.</td>
</tr>
<tr>
<td>1992</td>
<td>Ghosh Committee</td>
<td>Examine and Advise on Greater or Full Disclosure in the Published Accounts of Banks in India</td>
</tr>
<tr>
<td>1994</td>
<td>Saraf Committee</td>
<td>To Suggest Ways And Means to Improve Payment System with the Help of Technology.</td>
</tr>
<tr>
<td>1995</td>
<td>Rashid Jilani</td>
<td>To Examine Efficacy and Adequacy of Internal Control Systems in Banks and to Suggest Improvements.</td>
</tr>
<tr>
<td>1996</td>
<td>Shere Committee</td>
<td>To Propose Legislation on Electronic Funds Transfer.</td>
</tr>
<tr>
<td>1996</td>
<td>Padmanabhan</td>
<td>To Recommend on On-Site Supervision of Banks.</td>
</tr>
<tr>
<td>1997</td>
<td>S. H. Khan</td>
<td>Harmonizing the Roles of DFIs and Banks.</td>
</tr>
<tr>
<td>1997</td>
<td>S. Narasimham</td>
<td>Banking Sector Reforms.</td>
</tr>
<tr>
<td>1999</td>
<td>M. S. Verma</td>
<td>To Suggest Measures for Revival of Weak Public Sector Banks.</td>
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</table>
Critical and noteworthy reforms in the financial system during the reform period included the following (Bhide, Prasad and Ghosh, 2001):

- Lowering of statutory reserve requirements to the current levels of 5 percent for cash reserves and 25 percent for statutory liquidity ratios.
- Liberalizing the interest rate regime, allowing banks the freedom to choose their deposit and lending rates.
- Infusing competition by allowing more liberal entry of foreign banks and permitting the establishment of new private banks.
- Introducing micro-prudential measures such as capital adequacy requirements,
income recognition and asset classification and provisioning norms for loans, exposure norms and accounting norms.

- Diversifying ownership of public sector banks by enabling the state-owned banks to raise up to 49 percent of their capital from the market.
- Mandating greater disclosure in the balance sheets to ensure greater transparency.
- Adopting a consultative approach to policy formulation with measures being ushered in after discussions with market participants to provide useful lead-time to market players to make necessary adjustments.

An important objective of reforms in India has been to integrate the various segments of the financial market for bringing about a transformation in the structure of markets, reducing arbitrage opportunities, achieving higher level of efficiency in market operation of intermediaries and increasing efficiency of monetary policy in the economy (Reddy, 1999). Banks were compelled to be constantly on the look out for stable alternate sources of earnings in the form of non-traditional and fee based sources of incomes (Karunagaran, 2006). The Reserve bank of India, permitted banks to diversify their activities to innovative banking and non-banking products like bancassurance, investment related activities, merchant banking, lease financing and so on. Liberalization, Privatization and Globalization (LPG) shows a breathtaking process for existence and growth of the banking sector.

Banks have improved significantly due to reformatory measures which are reflected in their market valuation, innovation, growth and value creation. Deregulation, liberal entry norms for private and foreign banks have brought cut-throat competition in the banking sector. As a result, more and more banks are becoming diversified and modern in their approach. Changing customer’s perception and rapid expansion of trade has resulted in application of more automation along with wide range of product & services from insurance to securities underwriting and corporate consultancies etc. In this era, trend towards consolidation has emerged in order to have competitive, profitable and healthy financial sector. The major advantage accruing from consolidation would be to increase the size of banking operations thereby providing banks with the requisite
financial strength to take on global competition (Ahuja, 2009). The trend towards mergers and acquisition (Table 1.2) can be interpreted as the outcome of moves to achieve these goals (Berger et al., 1999).

Table 1.2 List of Mergers and Acquisitions

<table>
<thead>
<tr>
<th>Year</th>
<th>Bidder Bank</th>
<th>Targeted Bank</th>
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<tbody>
<tr>
<td>2001</td>
<td>Bank of Baroda</td>
<td>Benaras State Bank</td>
</tr>
<tr>
<td>2002</td>
<td>Punjab National Bank</td>
<td>Nedungadi Bank</td>
</tr>
<tr>
<td>2004</td>
<td>Oriental Bank of Commerce</td>
<td>Global Trust Bank</td>
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<tr>
<td>2004</td>
<td>Bank of Baroda</td>
<td>South Gujrat Local Area Bank</td>
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<tr>
<td>2005</td>
<td>Centurion Bank of Punjab</td>
<td>Bank of Punjab</td>
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<tr>
<td>2005</td>
<td>Centurion Bank of Punjab</td>
<td>Lord Krishna Bank</td>
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<tr>
<td>2006</td>
<td>Federal Bank</td>
<td>Ganesh Bank of Kurundwad</td>
</tr>
<tr>
<td>2006</td>
<td>IDBI Bank</td>
<td>United Western Bank</td>
</tr>
<tr>
<td>2007</td>
<td>Indian Overseas Bank</td>
<td>Bharat Overseas Bank</td>
</tr>
<tr>
<td>2007</td>
<td>ICICI Bank</td>
<td>The Sangli Bank</td>
</tr>
<tr>
<td>2008</td>
<td>HDFC bank</td>
<td>Centurion Bank of Punjab</td>
</tr>
<tr>
<td>2008</td>
<td>State Bank of India</td>
<td>State Bank of Saurashtra</td>
</tr>
<tr>
<td>2010</td>
<td>ICICI Bank</td>
<td>Bank of Rajasthan</td>
</tr>
</tbody>
</table>

Source: Capital Market, Jun28-July 11, 2010

Bank mergers can be a potentially important tool for improving the efficiency in the system in a highly fragmented environment in terms of size, number of branches, ownership structure, profitability and competitiveness (Mihaljek, 2005). Reserve Bank of India and government has indicated that the Indian banking industry had to transform itself from large number of small banks to small number of large banks to reduce risks to financial stability. State Bank of India had merged its subsidiary, State Bank of Saurashtra in 2008 and has received approval from government for amalgamation with another subsidiary, State Bank of Indore, in which it holds of majority stake i.e., 98.05% (Capital Market, July 2010).
Banks in India are not only diversifying their products and services within domestic limits rather they are expanding their operations overseas also. State Bank of India (SBI) has acquired a bank each in Nigeria and Kenya and picked up 51 per cent stake in a bank in Mauritius and 76 per cent stake in an Indonesian bank. (Bandyopadhyay, 2005). ICICI Bank has acquired Investitsionno-Kreditny Bank in Russia. The banks with an international presence have been forced to reanalyze their performance and approach. The entry of foreign banks has tended to lower interest margins, profitability and the overall expenses of domestic banks (Clarke, Cull, D’Amato and Molinari, 2000; Claessens, Demirgüç-Kunt and Huizinga, 2000). A number of foreign banks have shown interest in acquiring a stake in Indian banks. The three biggest foreign banks in India namely, Citibank, HSBC and Standard Chartered are looking at playing bigger roles in consumer banking in their portfolios while also aiming to expand in rural markets (Vipul, 2006). By the year 2009-10, five other banks namely Royal Bank of Scotland, Switzerland's UBS, US-based GE Capital, Credit Suisse Group and Industrial and Commercial Bank of China are going to set up their businesses in India (Vasant et al., 2010).

1.4 Major Facilitators for Diversification in Banks in India

In the following text, major facilitators for diversification in banks in India are discussed. These are the factors, which have driven banks towards diversification.

Competitive Environment

Liberal policies facilitate to increase market competition among banks to augment efficiency and productivity by the management to choose independent decisions about input-output and their prices by individual banks (Datta, 2006). The reforms brought about structural changes in the financial sector succeeded in easing external constraints on its operation, introducing transparency in reporting procedures, restructuring and recapitalizing banks and enhancing the competitive element in the market through the entry of new banks (Talwar, 2004). The synergic effect of
deregulation and adoption of prudential norms is likely to lead to higher level of efficiency, better resource allocation, innovation of products and process by diffusing competition among participants (Datta, 2006).

Nowadays, banks are not only facing competition from domestic banks but also from foreign banks, trust companies, life insurance companies, mutual fund companies and independent financial brokers and other non-banking financial intermediaries. New generation private banks like, HDFC and ICICI bank has given tough competition to public sector banks, especially in the retail banking business like home, car and personal loans, etc. The entry of new private banks and foreign banks have promoted competitiveness by introducing new product mix, client mix, geographical area, advanced technology and appropriate human resource management practices. To face competition, banks are focusing on strategic acquisitions as well as looking at other areas to maintain revenue growth.

**Retail Banking and Micro Banking**

In the present scenario, banks are focusing more and more on the retail banking and micro banking as this sector is expected to grow at a rate of 30% (Kochhar Chanda, ED, ICICI Bank, 2009). Retail Banking Industry in India covers industry segments like housing loan, auto loan, personal loan, education loan, consumer durable loan, credit card, bancassurance and many other product and services. Banks are making every effort to meet consumer demand through customized banking service. For example, banks specially like ICICI and HDFC often take the Direct Selling Agent (DSA) route, loan mela or a road show to sell personal loans, home loans etc. to capture retail market. Andhra Bank, Bank of Baroda, State Bank of India, Citibank, HDFC Bank, HSBC, IDBI, Indian bank, Indian Overseas Bank, ICICI Bank, ING Vysya Bank are some of the few banks which are adopting retail banking at strategic level. In the overall banking industry, retail banking in India has witnessed enormous growth in the recent past. The higher growth of retail lending in emerging economies is attributable to fast growth of personal wealth, favourable demographic profile, rapid development in information technology,
the conducive macro-economic environment and financial market reform (Industry Report of Retail Banking in India, 2009). In a move to boost micro finance movement in India, the Reserve bank, NABARD and SIDBI have taken initiative to set up separate micro finance institutions (MFIs).

Decline in interest margins

Declining interest margin is a recent development, which has been accelerated by globalization but, on the other hand, globalization also leads to a rapid growth of international trade, which in turn provides opportunities in the fee business (Gischer and Juttner, 2003). Hence, to compensate for the adverse development in the interest business banks looked for other income sources (Koetter et al., 2004). For some banks it has opened up new markets, particularly in trading, asset management and investment banking activities (Davis and Tuori, 2000). In India, deregulation of the interest rate structure, lowering reserve ratios, increased competition, etc. have facilitated lowering of interest rates on both sides of balance sheet and interest spread in line with international standards. This trend has compelled banks to expand and diversify their operations towards non-traditional products and services via owning own specialized subsidiaries and non-traditional fee based services to stabilize their earning. Thus, non-interest fee based income has become a significant source of revenue for the banks. The Reserve Bank of India has stated in its report on “Trend and Progress of Banking in India (2003-04)” that “the fall in the interest income has been to a large extent compensated by the rise in income from non-interest income generating sources”. Diversification of banking activities helps banks to gain non-interest income and sustain profitability (Shirai, 2001). In the era of declining interest margin, the private sector and foreign sector banks continue to score significantly over the public sector banks in fee income generation driven by their strong IT platforms that help cross selling and meeting many needs of the customers (Srinivasan and Batra, 2007).
As shown in (Fig. 1.2), The share of non-interest income in total income was steadily increasing during the period 2002-2004 but declined in the subsequent period i.e. 2005-06 due to market fluctuations. For the last three years however this share is again witnessing a rise, with a corresponding decline in share of interest income. A steep increase in non-interest income from the year 2006 onwards is attributable to the pressure on interest margins which results in squeezed interest margins. Another reason is that, during the year 2006-07 and 2007-08, economy has been grown at an unprecedented rate of 9.4 percent, due to which, the demand for fee-based services has gone up and as a result of which, non-interest income has also risen up.

**Risk Management and Compliance Scenario**

Broadly, banks are exposed to three types of risk namely credit risk, market risk
and operational risk in respect of their business. The BASEL Committee on Banking Supervision has advocated a risk-based supervision of banks, as stability of the financial system has become the central challenge to bank regulators and supervisors throughout the world. RBI has issued guidelines regarding the implementation of BASEL II. The Bank of International Settlements attempts to put in place sound frameworks of measuring and quantifying the risks associated with banking operations (Agarwal and Sirohy, 2010).

Basel II adopts a three-pillar approach to risk management as under:

Pillar 1 Minimum capital requirements are stipulated for credit risk, market risk and operational risk.

Pillar 2 Deals with supervisory review process by the central bank.

Pillar 3 underlines the need for market discipline and disclosures required there under.

In India, Reserve Bank of India stipulated a minimum capital adequacy of 9 percent. The Risk Management and compliance scenario will get strengthened with the liberalization, regulation and integration of global markets. The adoption of Basel II framework has helped SCBs in India to aligning the banks’ regulatory capital with economic capital and thus ultimately improving capital efficiency.

**Customer Centricity Concept**

Banks nowadays are giving strategic focus to customer centricity concept stressing on maintaining effective customer relationship. For this purpose banks are using many strategies namely Customer-Centric Banking namely, Customer Information Management (CRM), Multi-Channel Integration, Operational Excellence and Intelligence and Real-Time Cross-Selling. Public sector banks in India are gradually shifting their emphasis on customer orientation from account orientation. With the help of Customer Relationship Mechanism (CRM) bank are making a positive endeavor to ensure enhancement in the profitability ratio by cross-selling more products to the existing customers. Private sector and foreign sector banks are a head of public sector banks in this respect. Although their customer coverage base is low as compared to public sector
but they generate steadily high business from cross selling and up-selling because of effective customer relationship management. During 2008-09, focused attention is given to the customer service dimension of the banking sector by sensitising banks to render good and efficient customer service and encourage involvement of Boards of banks in evolving policies keeping in view the needs and aspirations of customers (Report on trend and progress of banking in India, 2008-09). The Reserve Bank has created a full-fledged Customer Service Department to develop customer friendly environment and handle customer grievances.

**Investment in technology**

Information Technology has become an integral component of banking. Therefore, banks are giving strategic priority to investment in technology in order to have automated banking processes. Customers have also, enthusiastically adopted new technologies and electronic banking system. Advanced technology helps banks in meeting customer’s service expectation, reducing operational costs and managing competition. With centralized infrastructure and numerous connectivity options, banks are exploring multiple delivery channels like ATM, net-banking, mobile banking and tele-banking with the aim of driving down cost per transaction (Patric, 2003). During the year 2008-09, the coverage of the number of bank branches providing Core Banking Solution (CBS) has increased to 44,304 as on March 31, 2009 from 35,464 as on March 31, 2008. During 2008-09, the total number of ATMs installed by the banks grew by 25.4 per cent, with number of ATMs of SBI Group registering a sharp growth of 34.5 per cent, while, the ATMs installed by new private sector banks and foreign banks were more than 3 times of their respective branches, the ATM to branch ratio was much lower for other bank groups (Report on trend and progress of banking in India, 2008-09).

1.5 **Benefits of diversification in banks**

Diversification in the banking sector has emerged from a host of considerations. Diversification helps a bank in eliminating the unevenness of geographical reach, product-process innovation, exploit economies of scale and scope, reap benefit of advanced technology and diversify risk along with mobilization of additional capital. On
the liabilities side, banks have a diversified set of depositors with different withdrawal patterns (Diamond and Dybvig, 1983). On the asset side, portfolio diversification directly follows from risk aversion on the part of the financial intermediaries under incomplete markets (Mallick, 2008). Berkovitch and Narayanan (1993) and Ali-Yrkko (2002), classify the banks motive to diversify as synergy (or economic) motive, managerial motive, value maximization motive, increased market power motive, capital strength and risk diversification motives etc. Montgomery (1994) emphasizes on three perspectives on diversification namely the market power view, the resource view and the agency view. The literature on diversification asserts that diversified firms can employ a number of mechanisms to create and exploit market power advantages that are largely unavailable to their more focused counterparts (Caves, 1991).

Resource sharing

Resources could be used and shared because they are related in terms of sharing markets, distribution systems, product and process technologies or manufacturing facilities (Ansoff, 1965; Rumelt, 1974) or because they rely on common technologies, managerial capabilities and routines (Grant, 1988; Nelson and Winter, 1982; Prahalad and Bettis, 1986; Winter, 1987). The sharing of activities and resources lead to unit cost savings and enhanced differentiation (Bruche, 2000). The ability to use firm-specific resources extends a competitive advantage from one market to another (Wernerfelt and Montgomery, 1988). Economies of scope, a widely accepted motive for related diversification, arises when the joint cost of producing two or more outputs, including all costs incurred from transforming raw materials to delivering the final products to customers, is less than the sum of the production costs of each output by itself (Panzar, Baumol and Willig, 1988). The benefit from diversification for banks would derive from economies of scope (Klein and Saidenberg, 1997).

Cross-selling of products and services

By offering a broader set of financial products than a specialized bank, a diversified bank can develop wider and long-term relationships with customers (Santos, 1998). A wider bank-customer relationship may be a source of scope economies. It gives
the bank the opportunity to cross-sell its product and services by using the information gained in monitoring a firm’s checking account in various businesses rather than just in lending decisions. Above all, banks can also use their branch networks and all other existing delivery channels to distribute additional products at low marginal cost (Llewellyn, 1996). Bancassurance has been an important trend in mature markets, partly driven by the idea of cross-selling products through bank branches. Further, the reputation gained in offering one service can use to recommend their other services in universal and diversified banks. Diversification enables banks to maintain long-term relationships with clients throughout their life cycles and gives them an incentive to process inside information and monitor their clients (Shirai, 2001).

Complementary nature of financial products

The complementary nature of some banking, insurance and investment products enables banks to reduce the search and transaction costs for their existing customers, wishing to extend the range of financial products they purchase. Thus, the diversification of banking operations results in commercial banks to embrace nearly all functions such as merchant banking, leasing, wholesale banking, mortgage finance and asset management, among others. Banks can stabilize their income by engaging in activities whose returns are imperfectly correlated, thereby reducing the costs of funds and thus lending and underwriting costs (Shirai, 2001).

Conglomerate power

Diversified firms are more efficient than other firms as they have conglomerate power, which make them, thrive on their diversity (Hill, 1985). Lindstrom (2005) highlights the anti-competitive actions often associated with motives for diversification. The diversified companies are able to exploit, extend or defend their power by strategies and tactics (Montgomery, 1994). A firm can profitably employ its underused resources, which provide an incentive to expand. Diversification can generate efficiencies that are unavailable to the single-business firm (Gertner, Scharfstein and Stein, 1994).
Risk Diversification

Companies can use diversification to reduce unsystematic risk, i.e. the risk inherent in investing in particular industries (Simmond, 2009). Deregulation and the resulting intensified competition for market share, have forced banks to engage in risk-taking activities. As a result, risk-taking would reduce the value of banks’ future earnings and associated incentives to avoid bankruptcy (Allen and Gale, 2000). The fundamentals in portfolio theory emphasize that “one should not put all the eggs in one basket”. If cash flows from individual operations in a firm are not perfectly correlated, the risk can be reduced by diversification. Broadly, diversification are of two types namely, geographic and product diversification. Geographical diversification offers a reduction of risk, because the return on loans and other financial instruments issued in different locations may have relatively low or negative correlation. In a similar manner, relatively low or negative correlation of different financial services industries may result in reduction of risk. For example, (Berger et al., 2000) found that correlations of bank earnings across international borders are often very low or negative, thereby supporting the possibility of diversification benefits from cross-border consolidation of banking. The diversified firm can attract external funding for expansion, but it can also shift capital and other resources, for that matter between businesses within its portfolio (Meyer, Milgrom and Roberts, 1992). Verweire (1999) shows that the risk profile of financial conglomerates is better than that of specialized suppliers (specialized banks and specialized insurance companies). 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.

1.6 Fallacies of Diversification

Although there are several benefits associated with diversification, there are also possible costs arising from potential organizational inefficiencies through the complexity of hierarchical structures increasing coordination costs, employee shirking (imperfect monitoring) and the costs of learning a new business.
Diversification may help to spread risk, but it may also add to risk if the new areas of business are clearly more risky, on average, than existing ones. For example, derivatives involve higher speed and greater complexity, which may reduce the solvency and transparency of banking operations (Shirai, 2001). Diversification may not always reduce the risk of bank failure, pointing to the benefits and costs of monitoring loans and the possibility that diversification may lead banks into new sectors in which they might have less expertise (Winton, 1999). Financial consolidation may not always create market power and desired diversification effect for large financial institutions and various features of conglomeration may actually increase the scope for instability, in particular when they lead to a small number of large conglomerates, which are too big to fail, to discipline and to liquidate (Ham and kin, 2004). Further, involvement of banking in securities and underwriting services may lead to conflicts of interest between banks and investors.

There are certain other possible costs of diversification e.g.

- Agency problems afflicting diversifying investments (Jensen, 1986; Meyer et al., 1992),
- Inefficient internal resource allocation due to malfunctioning of internal capital markets (Lamont, 1997; Rajan et al., 2000).
- Informational asymmetries between head office and divisional managers (Harris et al., 1992).
- The volume of activities might get affected (Scharfstein and Stein, 2000),
- Bargaining problems (Rajan et al., 2000)
- Bureaucratic rigidity (Shin and Stulz, 1998).
- May not be able to completely diversify the risk associated with their assets because markets are incomplete or because their monitoring technologies are not perfect (Santo, 1998).
- The increased governance costs and weaker relationship to core operations outweigh the benefit of increased diversification (Jones and Hill, 1988)
- As banks diversify into dissimilar business prospects, it becomes difficult for
managers to have adequate understanding of every operation. This leads to the problem of internal control systems. In response, corporate executives shift the internal control mechanism from strategic to financial controls to evaluate divisional performance (Hoskisson & Hitt, 1988; Jones & Hill, 1988).

- The reliance on financial control systems could motivate division managers to focus on short-term financial results and sacrifice long-term risky strategies, such as R&D investments (Baysinger & Hoskisson, 1989; Delios & Beamish, 1999; Hoskisson & Hitt, 1988).

- Under certain situations, managers may prefer to undertake actions that run counter to the long-term wealth of shareholders (Chang, Wang and Chen, 2009). For example, managers may want their firms to engage in diversification not because this strategy could generate value for the firm, but because they might derive private benefits ranging from the power and prestige associated with managing a larger firm (Jensen, 1986; Stulz, 1990), managerial compensation related to firm size (Jensen & Murphy, 1990), a reduction in the risk of managers’ personal portfolios (Amihud & Lev, 1981), to the entrenchment of themselves by making manager-specific investments (Shleifer & Vishny, 1990).

- When banks keep diversifying their portfolios, the ability to monitor the new or the marginal borrowers may fall and there also might be a disincentive to monitor in general, leading to possibilities of accumulation of bad debt and even bank collapse (Winton, 1999).

Past experience, such as the stock market collapse in the wake of the Ketan Parekh affair, point to the dangers inherent in such diversification, this increases bank fragility substantially (Frontline, March 2002). This increase in fragility is all the more disturbing since it occurs in a context where mergers and acquisitions involving foreign and Indian banks are resulting in consolidation and increasing the size of entities that could be adversely affected (The Hindu, March 15, 2002). Complexity in operation and incentives to take on more risks based upon ‘too-big-to-fail’ may actually increase financial risks of large conglomerates. Under universal banking, potential systemic effect of a bank failure could be far greater (Suarez, 1997). Moreover, Efficiency may decrease if the consolidation creates organizational diseconomies to operate a larger, more diverse enterprise or makes it difficult to serve some segments of the market (Berger et al., 2000).
1.7 Diversification Models

A wide range of organizational structures has been developed to pursue diversification and form of financial conglomerates. Financial conglomerates also differ in the manner by which they have evolved into financial behemoths (Herring and Santomero, 1990). It would be a mistake to consider financial conglomerates as a set of homogeneous groups of financial firms with similar characteristics (Berghe and Verweire, 1998). The structural forms these entities take to achieve convergence vary across jurisdictions and are dependent on the host country’s regulatory and supervisory structures, legal environment, culture, system of taxation, historical development of the financial services industry, market concentration, degree of internationalization, the existence of scale and scope economies and cost efficiencies. Herring and Santomero (1990) have proposed three basic models for organizing a financial conglomerate, based on the degree of legal and operational separateness.

Model 1: The Universal Banking (German model)

In “the universal banking”, form of organization structure, both traditional banking and the non-traditional activity can be conducted in a thoroughly integrated manner and consolidated within the same corporate entity of bank. In this model (Fig. 1.3), managers are allowed to conduct all activities within a single corporate entity. In this case, there is no legal or operational separateness exists, although the financial conglomerate may choose to establish Chinese walls in order to enhance the perceived value of its services to potential customers (Herring, 1990). This organizational structure allows the bank to maximize the synergies between traditional and non-traditional activity and to gain the maximum amount of smoothing from the combined income flows (Shull and White, 1998). However, from the viewpoint of public policies, there might be strong concerns over such a form because of the potential for anti-competitive behavior, conflicts of interest and the potential risk of contagion (systematic risk) (Koguchi, 1993).

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2 Taken from “Supervision of Financial Services in the OECD Area” available online at www.oecd.org/dataoecd/29/27/1939320.pdf
Fig. 1.3: The Universal Banking (German model)

<table>
<thead>
<tr>
<th>Commercial Banking Activities</th>
<th>Investment Banking Activities</th>
<th>Insurance Activities</th>
<th>Other Financial Services</th>
</tr>
</thead>
</table>

Source: Shull and White (1998)

**Model 2: Bank Parent with Non-Banking Subsidiaries (British Model)**

In this model (Fig. 1.4), there is a legal separateness in the sense that the banking function is conducted in the corporate bank parent and non-bank functions are conducted in separately incorporated subsidiaries (Herring, 1990). As compared to the German model, operational efficiency is less in this model limiting the economies of scope potential. On the other hand, this organizational form has several merits, for example, the loss in a business can be of limited nature, tax benefits can be exploited and the costs of regulatory oversight are reduced (Herring and Santomero, 1990; Koguchi, 1993). This model is the basis of the organization structure where parent financial services (banks, securities or insurance) own subsidiaries in different financial sectors (Yoshino et al., 2007). While model still allows for risk diversification and cross-selling of financial services to increase revenues, it can reduce the potential for conflicts of interest and the extension of the safety net as the firewall that exists between the bank parent and its subsidiaries (Claessens, 2002).

Fig. 1.4: Bank Parent with Non-Banking Subsidiaries (British Model)

Source: Shull and White (1998)
Model 3: Financial Holding Company Structure (US Model)

In the US model form of organization structure (Fig. 1.5), the holding company is the sole owner of the banking subsidiary and its non-banking counterparts. The bank operates in one subsidiary of a holding company and the non-traditional activity is in another subsidiary of the holding company. Potential for conflict is reduced and the extension of the safety net may be limited (Santos, 1998). In this form of organization structure, the separation of the bank from its new activities would result in less synergy as compared to universal banks. The exchange of information, personnel and other inputs among the various units within the conglomerate is limited, thus reducing scale and scope economies and the bank’s ability to exploit synergies from informational advantages (Claessens, 2002). Economies of scope and the smoothing of income flows that occur as a consequence of diversification are, for the most part, likely to benefit the owners of the holding company as the efficiency of the bank itself and its income flows and thus its risks of insolvency from the variance of its income stream alone, will not be directly affected (Shull and White, 1998).

**Fig. 1.5: Financial Holding Company Structure (US Model)**

```
Holding Company

<table>
<thead>
<tr>
<th>Commercial banking subsidiary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-banking subsidiaries</td>
</tr>
<tr>
<td>Investment activity</td>
</tr>
<tr>
<td>Insurance activity</td>
</tr>
<tr>
<td>Other financial activity</td>
</tr>
</tbody>
</table>
```

*Source: Shull and White (1998)*
This classification is interesting because it points out that differences in corporate structure may have implications for the conglomerate's performance in terms of profit potential and risk level (Verweire, 1999). But these classifications are theoretical to be used in practices, specifically in banking sectors. However, practice shows that some financial conglomerates have set up organizational structures which might be totally different from the legal structure, and which might be a more important determinant of the economies of scope and the risk level within a financial conglomerate (Van den Berghe and Verweire, 1998).

### Table 1.3 Organizational Structures of Financial Conglomerates

<table>
<thead>
<tr>
<th>Model</th>
<th>The Universal Banking (German Model)</th>
<th>Bank Parent With Non-Banking Subsidiaries (British Model)</th>
<th>Financial Holding Company Structure (US Model)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governance of the parent company by shareholders</td>
<td>Bank shareholders govern all businesses (banking, securities and Insurance).</td>
<td>Bank shareholders directly govern banks and indirectly govern securities and Insurance companies.</td>
<td>Shareholders indirectly govern all subsidiaries in the banking, securities and insurance sectors.</td>
</tr>
<tr>
<td>Execution of business by executives of the parent company</td>
<td>Bank executives directly execute operations in each business</td>
<td>Bank executives directly execute the banks business and exercise rights for share held in securities and insurance companies.</td>
<td>Holding company executives exercise rights for share held in various subsidiaries.</td>
</tr>
<tr>
<td>Capital relationship between business sectors</td>
<td>No legal separation of capital in different businesses (allocation of capital to each business for internal management purposes is possible.)</td>
<td>Banks, securities and insurance companies hold their own capital. Potential exists for problems between parent companies and subsidiaries such as double gearing of capital.</td>
<td>The bank operates in one subsidiary of a holding company and the non-traditional activity is in another subsidiary of the holding company.</td>
</tr>
<tr>
<td>Risk insulation between business sectors</td>
<td>It is difficult to insulate risks between businesses, safety net effects on one business extend directly to others.</td>
<td>It is possible to insulate against risk to some extent. Safety net effects on parent bank may extend to subsidiaries.</td>
<td>It is relatively easy to insulate against risks. Safety net effects on one sector do not extend indirectly to others.</td>
</tr>
</tbody>
</table>

**Source:** Financial Conglomerates and Mix of Finance and Commerce by Jae-Ha Park (2006) cited from Financial Conglomeration in East Asian Regional Development, Daiwa Institute of Research, Ltd., 2007
Other Less Integrated Arrangements

This includes arrangements for offering related and un-related, banking and non-banking product and services through joint ventures, cross-shareholdings, distribution alliances and other formal arrangements.

1.8 Diversification Strategies

Ansoff (1965) has elaborated four types of diversification strategies in diversification strategy matrix. This is explained in (Fig. 1.6).

**Fig. 1.6: Diversification Strategies Matrix**

(Source: Ansoff, 1965)

In this diversification strategies matrix (Fig. 1.6), the diversification in corporate sector starts from the characteristics of products and customers in relation to the present product market position (Berghe and Verweire, 1988). The diversification can either be horizontal, vertical, concentric and conglomerate. Diversification is undertaken to bring about efficiency gains via vertical integration or to spread risk and acquire special assets via horizontal extension (Baldwin et al., 2000).
**Horizontal diversification** is a diversification strategy entailing expansion and moving into other industries at the same stage of the industry chain. Horizontal diversification occurs when a firm extends its production activities into areas that fall outside of its traditional product line to exploit complementary marketing or technological assets across product lines (Baldwin et al., 2000). It also serves as an important means of risk-spreading, safeguarding corporate revenues from demand shocks in key product markets.

**Vertical integration** occurs when a firm expands the scope of its activities to its suppliers or customers. It refers when a firm diversifies by incorporating previously provided by a supplier (backward) or a customer or distributor (forward). Vertical diversification strategies bring together, within a single operating structure, discrete elements of the production and distribution chain. Firms that establish vertically integrated structures may be able to allocate resources more effectively than via arms-length transactions (Williamson, 1975).

**Related - concentric diversification** occurs when a firm adds related products or markets in order to achieve strategic fit and synergy. Related diversification implies having a product portfolio containing different products within the same industry. Synergy may be achieved by combining firms with complementary marketing, financial, operating or management efforts. Related diversification is said to occur when new investments involve similar product

- When they lead to the vertical integration of complementary activities (corresponding to backward or forward integration);
- When firms internationalize by adding operations in foreign markets which involve similar products (even if these investments take place in culturally and geographically distant markets);
- When the new business shares intangible assets such as marketing knowledge, patent protected technology, product differentiation, superior managerial capabilities, or routines (Nelson and Winter, 1982; Winter, 1987).
**Unrelated - conglomerate diversification** occurs when a firm diversifies into areas that are unrelated to its current line of business and entity has a product portfolio containing products from different industries. Major reason for pursuing a conglomerate growth strategy by banks is that opportunities in current line of business are limited. So they adopt conglomerate diversification strategy as a means of increasing the firm's growth rate. Firms are considered to have conglomerate or unrelated businesses when they are diversified into areas where no physical or knowledge resources are shared, other than financial (Stopford and Dunning, 1983; Wrigley, 1970; Rumelt, 1974). For example, banks have diversified into offering products (and services) such as mutual funds, venture capital, depository services, bullion trading and credit cards.

In another approach, in (Fig. 1.7), Rumelt (1974) has classified firms into four business groups strategies namely, single business firm, dominant business, related business firm and unrelated business firms.

**Fig. 1.7: Rumelt’s Strategic Classes**

**Rumelt has classified firms into four business groups:**

Specialization ratio: - proportion of a firm’s revenue derived from its largest single business

Related ratio: proportion of a firm’s revenue derived from its largest single group of related business

**Source:** Rumelt, 1974
• Single business firm- when 95% or more of its revenues are generated from one business;
• Dominant business firm- when 70 – 95% of revenues are generated from principal activity;
• Related business firm- when less than 70% of revenues are generated from principal activity but other lines of business are related;
• Conglomerate firm- when less than 70% of revenues are generated from the principal activity and has other unrelated businesses (Rumelt, 1974).

1.9 Diversification patterns and modes applied in banking sector

Broadly, banks may diversify through internal diversification or through outward expansion i.e. external diversification. Internal diversification refers to marketing of existing products in new markets while external diversification occurs when a firm looks outside of its current operations and buys access to new products or markets (Thomas, 1999). Diversification of business could be within the same organization, when it undertakes permissible non-banking activity, or it could also be at group level, when a bank sets up separate subsidiaries to undertake non-banking activities. Internal diversification of banks refers to taking up of non-traditional activities within the organization, which is more relevant from the efficiency point of view. Internal growth opportunities for commercial banks depend on the ease with which operating efficiencies, scale economies and scope economies can be exploited (Walter, 1997).

Wood (1971) has defined two patterns of diversification i.e., NSD (Narrow Spectrum Diversification)-related diversification and BSD (Broad Spectrum Diversification)-unrelated diversification. These two types of categorizations have been used along with a third category that is AD (Alliance Diversification) to study the nature of diversification in banks. BSD is expansion, other than vertical integration, into an industry with different first two digits of the standard industry code (SIC) while NSD is expansion, other than vertical integration, into an industry with a different four-digit industry code, but the same first two digits (Hendrikse and Oijen, 2002). BSD can be viewed as unrelated diversification, whereas NSD represents related diversification (Varadarajan and Ramanujam, 1987). Related diversification entails the entry of a
company into an industry, which is related to the current activities of the company in its value chain (Porter, 1985). The similarities are usually in production, marketing of technology. In related diversification, there is an evidence of potential synergy between the new business and the core one, based on a common facility, asset, channel, skill, even opportunity (Mintzberg, 1988). Unrelated diversification entails the entry into an industry, which has no significant relationship with current activities (Hendrikse and Oijen, 2002). It entails spreading of an investment portfolio over a wide range of unrelated products by the business group, so the common features are generally limited to finance and business management (Baldwin et al, 2000).

In another approach given by Lafferty Business Research, 1991 and 1994; Hoschka, 1994, stress is given on the entry strategies of banks into the insurance and other line of businesses. Specifically for banks entering the insurance industry, (Hoschka 1994, as cited in Verweire 1999) identified four possible alternative entry vehicles towards integration. The approach is given graphically in (Fig.1.8).

**Fig. 1.8: Alternative Entry Vehicles for Banks Entering Insurance and other services**

<table>
<thead>
<tr>
<th>Level of Integration</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>De novo entry or internal diversification -&gt; greenfield entry with own underwriting or insurance entities: since capital resources are conjoined in a conglomerate, management advantages and economies in terms of better brand strategizing techniques can be reaped (Van Lelyveld and Schilder, 2002).</td>
<td></td>
</tr>
<tr>
<td>Merger/acquisition -&gt; combination and integration of two separate corporations either through merger or control acquisition</td>
<td></td>
</tr>
<tr>
<td>Joint venture -&gt; jointly owned separate legal entity underwriting insurance</td>
<td></td>
</tr>
<tr>
<td>Distribution alliance-&gt; where a bank and an insurance firm enter into a co-operation agreement, concerning distribution area possibly supported by mutual shareholding</td>
<td></td>
</tr>
</tbody>
</table>

**Source: Hoschka, 1994, as cited in Verweire, 1999**
In Indian banking sector, a mixed pattern of diversification model is followed. While majority of the banks are diversified via complete integration (German model). While some banks like SBI and ICICI bank are following bank parent – non-bank subsidiaries (British model). State Bank of India has sixteen subsidiaries, five joint ventures and fifty associates in India and abroad.

1.10 Structure of the study

The present study is organized into seven chapters as follows.

Chapter one is introductory in nature. The concept of diversification is defined and discussed in detail. It acquaints the reader with the background on the development of diversification concept in banking. Different diversification strategies, patterns and modes as applied in the banking sector are discussed. The chapter outlines theoretically, the major facilitators of diversification and cost-benefits associated with the diversification in banking sector.

In the second chapter, review of literature on diversification of banking sector is given. The review has been approached in following three categories viz, (i) Review of literature on nature and extent of diversification (ii) Review of literature on determinants of diversification in banks (iii) Review of literature on financial implications of diversification in banking sector.

The research methodology and research framework applied in empirical research is explained in chapter three.

In Chapter four, the first objective of the study is analyzed i.e. to study the nature and extent of diversification in Indian banking sector.

The second objective is examined in chapter five. The various determinants for adopting diversification in Indian banks are analyzed as to why banks are diversifying into non-banking business besides their traditional businesses.
Chapter six focuses on the impact of diversification on financial performance of banks. The difference between the financial performance of diversified banks and non-diversified banks is investigated. In this chapter, the overall grouping’s (focused vs. diversified banks) and the impact of degree of diversification on financial performance of banks is also examined.

Major findings of the study are summarized in chapter seven. It is followed by the general discussions and conclusions of the work. Scope for further research is discussed at the end of this chapter.

At the end, an exhaustive and updated bibliography is given. The appendices contain questionnaire used for the purpose of collecting data and the list of banks.