Impact of Loan Portfolio Diversification on Financial Performance ofBanks: Evidence from Banking Sector in Sri Lanka

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Abstract

Lending is a significant part that needs to be highly concerned to maximize organizational performance in the banking system. The loan portfolio is treated as a major asset to the banks. Therefore, decision-makers of the banks need to properly manage loan portfolios through various strategies such as diversification and concentration. Further, it is a strategy for reducing credit risk as mentioned in the portfolio theory which assists to mitigate bankruptcy. However, there is no agreed consensus in the literature regarding theassociation of loan portfolio diversification and the financial performance of a bank. Therefore, this study analyses the impact of loan portfolio diversification on banks' financial performance. For this purpose, researchers considered licenced specialized and licenced commercial banks functioned during the period from 2014 to 2019, and data was collected from the audited financial statements of the respective banks. As per the data availability, the sample was ended with fourteen banks. Aligning with the literature, Herfindahl- Hirschman index was used to measure the loan portfolio diversification and the CAMEL model was used to measure the bank's financial performance. Accordingly, researchers used descriptive analysis, Person correlation, and regression analysis for analysed the collected data. The results found that there is a significant and negative relationship between loan portfolio diversification and bank performance. Moreover, it revealed that there is a negative relationship between loan portfolio diversification and capital adequacy as well. In the same vein, there is a negative relationship between loan portfolio diversification and earning, whereas a positive relationship between loan portfolio diversification and liquidity. Based on the result of regression analysis, it can be observed that loan portfolio diversification has the highest influence on liquidity. The result indicates that the diversification of the credit portfolio at the bank level is associatedwith better performance and lower risk and expects to have significant policy implications. These findings would contribute to expanding the current literature by highlighting the more researches on this theme is necessary to make a valid conclusion with large samples.

Keywords: CAMEL model, diversification, financial performance, loanportfolio