Impact of Loan Portfolio Diversification on Performance of Commercial Banks in Sri Lanka

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Credit risk attached with commercial bank loans can be considered as one of the main risks which commercial banks face. Thus, commercial banks diversify their loan portfolio to enhance performance through mitigating the credit risk. Loan portfolio diversification refers to providing loans to different sectors without concentrating on a particular sector. However, there is no consensus in the literature about the link between loan portfolio diversification and performance of commercial banks. Therefore this study examines the impact of loan portfolio diversification on performance of commercial banks in Sri Lanka. Hirschman Herfindahl Index was used to measure the loan portfolio diversification while performance measured by the CAMEL model. The Interest Rate Spread and Bank size were considered as the control variables. The sample consists of ten licensed commercial banks including six systemically important commercial banks in Sri Lanka out of 25 licensed commercial banks and the sample period spans for ten years from 2008 to 2017. The data were collected from published financial statements of sample companies and analyzed by using Pearson correlation coefficient and fixed effect panel regression model. The results revealed that there is a significant negative impact of loan portfolio diversification on performance of commercial banks. Further, both control variables-bank size and interest rate spread show a positive impact on performance of commercial banks. In conclusion, it is recommended that commercial banks should reduce their loan portfolio diversification as much as possible to increase the performance. The management should develop specific strategies on Loan Portfolio Diversification in order to improve the performance while paying high attention on loan portfolio position of the bank.

Keywords: Credit risk, Loan portfolio diversification, Loan portfolio concentration, Hirschman herfindahl index, Interest rate spread