THE EFFECTS OF THE DIVERSITY OF BANKING SERVICES ON BANK PERFORMANCE-A CASE OF THE IRAQI BANKING SYSTEM

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THE EFFECTS OF THE DIVERSITY OF BANKING SERVICES ON BANK PERFORMANCE-A CASE OF THE IRAQI BANKING SYSTEM

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Abstract
This paper examines the effect of diversification on the performance of various banks in Iraq. Previous studies suggest that banks which are less diverse in terms of services offered and clientele are monotonous and generate less revenue. Further, the performance of the bank is measured by its ability to meet its goals, increase its profit margin and build a good capital portfolio. This research deployed qualitative and quantitative approaches to collect and analyze data from 19 participants in 7 companies within the Kurdish region of Iraq. The eligibility criteria for selecting the participants was that those who were fully aware of the functionality of the banks were selected. The findings showed that the diversity of services offered or clients influence the performance of the bank. In conclusion, banks which offer a variety of services to several investments are poised to perform in the banking industry. Employees also play a vital role in strategies such as the evaluation of clients and sectors with lower credit risk and higher returns.
Keywords: *Diversification, bank diversity, bank performance, credit risk, credit portfolio*

Introduction

There is an increasing demand for diversification in various sectors, including banking (Asif and Akhter, 2019). Notably, financial institutions such as banks have incorporated this technique in their activities. The diversity of credit portfolio, for instance, boosts the growth and development of banks. Brahmana et al. (2018) also noted that cutting down the credit portfolio of a bank lowers the chances of risk. The diversification of various industries and sectors within the economy lowers bank returns and increases the percentage of risk in loans. Even if the risk was controlled, diversification would still be associated with declining bank returns. However, for a few cases of high-risk banks and diversified industry, bank returns are likely to increase.
According to Al-Khero et al. (2019), the majority of banks tend to increase their loan portfolio diversification even though they provide services from various sectors of the economy. Bigger banks are developing measures in place to diversify their loan portfolio. The sectors that are likely to perform well with time include those which are linked to savings banks, savings and credit cooperatives as well as other local organizations (Chai et al. 2016). There is limited literature on the diversification of bank services in the Middle East due to the incentives of various governments to distribute oil revenues among the population.

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Brahmana et al. (2018) stated that in the recent past, the Iraqi government had channeled the proceeds from the same oil into public expenditure, thus improving the delivery of services.

There is a need, therefore, to examine the impact of diversifying bank services in growth and performance. Banks play an essential role in the financial aspect of a country's economy. For more than thirty years, credit risk has been used to determine the performance of a financial institution (Al-Khero et al. 2019). Further, bank capital regulation has also been influenced by credit risk modelling. The Basel Accord of 1988 outlined the different weight risks for various asset classes on the bank balance sheet. The guidelines of the Basel II also affect credit risk modelling. Indeed, the credit risk models deployed in the management and regulation of risk assume various attributes of credit instruments. For instance, the recovery dates, exposure to loan defaults, or the probability of default. The risk models assume that historical data is a method of estimating the risk probability. Conclusively, the credit risk model refers to these features as loss distribution over a specific time frame.

Loss distribution usually results from such approaches of managing risks and can also be sued to determine the sizes of equity buffers other than supporting loans portfolio (Hashem, 2019). On the other hand, perceiving credit risk as originating from within contrasts the common belief of analyzing the credit risk concept. There is a massive difference between the endogenous and exogenous or standard credit risk models. The exogenous approach perceives credit risk to be closer to equilibrium, usually resulting from the integration of many decision agents.

Contrarily, the standard view perceives such analysis as an impending problem which is risky (Chai et al. 2016). The exogenous approach appears, therefore, appears problematic. There is a need to note that sufficient economic capital is needed to support a loan portfolio in the event of loan defaults. The purpose of this paper is to evaluate the performance of banks due to the diversification of banking services. The hypotheses of the current research were:

H1. There is a strong relationship between the diversity of banking services and the performance of selected banks.

H2. The diversification of banking services affects banks' performance negatively.

The objectives of this research is to evaluate various strategies that banks can employ to improve diversification and thus increase their profit margins. This research also intended to examine the relationship between the diversity of banking services and the improvement of the performance of the bank. Conclusively, this research aims at determining whether the diversification of banking services negatively impacts the growth and development of banks.

Research Questions

To achieve the goals of this research, this research aimed at addressing the following research questions:

1. Do selected bank's employees have the possibility of choosing diversification strategies to influence the bank activities?
2. Can the surveyed banks that have a strategy to diversify banking services influence a bank's performance?

Literature Review

In Iraq, several studies preview the diversification of the banking industry. The main reason behind the investigation of the diversification is that different investments are promising in

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terms of loan repayment and have lower loan risk compared to single investments. There is a need to research the history diversification and its effects on the performance of a bank.

The Definition of Diversification

Brighi and Venturelli (2016) argued that diversification is defined based on its impact within a certain field. Economically, diversification refers to the sum of squares of shares in different regions or products resulting from a more conventional approach. Generally, diversification refers to the loans, deposits, geography, and assets of a bank. Further, this concept evaluates the diversification framework and is based on the predicted costs and profits.

The Iraqi Banking System

The Iraqi banking industry is commonly grouped into private and state-owned banks (Mohsen, 2016). Private banks serve the needs of the Iraqi people, while state banks are meant to meet the financial requirements of the government. There is a need to note that some state-owned banks are also permitted to serve the financial requirements of the general public.

i) State-owned banks

Before the second Gulf war, there were six state-owned banks in operation. The Rafidain Bank, the Rashid Bank, the Industrial Bank, the Agricultural Bank, the Real Estate Bank and the Iraq Bank are the most common banking institutions owned by the federal government. The Rafidain and Rashid banks have the highest number of branches countrywide. In total, there are 170 Rashid Banks countrywide compared to 153 Rafidain Banks across the Arabian country. The Rafidain and Rashid Banks are recognized for their commercial loans to the general public. Further, state banks were started to meet the financial requirements of the Iraqi government (Mohsen, 2016). The state-owned banks were allowed to engage in commercial banking activities since 1997.

The Agricultural Bank was founded in 1936 mainly to provide financial services to the agricultural sector. With more than 40 branches countrywide, the total assets of the bank have risen to a stunning $52.8 million. The industrialization bank was formed after the split of the Agricultural Bank in 1940 (Mohsen, 2016). The clients of this financial institution are small and medium enterprises (SMEs) and various companies in the private sector. In 2003, the assets of the bank have reached $34.7 million with more than nine branches all over the country. The Real Estate bank, established in 1949, continues to provide loans to construction firms and the tourism industry.

ii) Private banks

The Central Bank of Iraq issued licenses to more than 25 private banks by October of 2006 after a successful twenty-three-year stint. These developments varied from those recorded in 2003 in which only eighteen banks had received licenses and were operational, having been founded during the 1990s. There was a huge expectation that the Iraqi economy would improve after the second Gulf War, and thus attract foreign and local investments (Amir, 2016). Further, there was anticipation that weaker banks would be thrown out of business through mergers and acquisitions, creating fierce competition in the banking industry. However, the expectations were not met, and only seven banks remained operational. There is a need to note that there was a bank limit since 2005, leaving the industry with only a few banks.

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The Kurdistan International Bank is ranked fourth among the largest banks in terms of market cap and the value of deposits. Mohsen (2016) pointed out that among the seven banks, there are five large banks with Kurdistan being the only Islamic bank. However, 47% of the gross revenue from banks emanates from fund transfers, foreign exchange transactions or commission (Hadian, 2016). The Kurdistan International Bank also noted that by 2006, Islamic activities such as Murabaha, Mudharabaa, and Musharaka accounted for 43% of the total revenues. There are various types of banks operating in Iraq. They include deposit banks, development and investment banks, and participation banks.

The main function of deposit banks is to grant loans, receive cash deposits and operate within the stipulates of the law (Hashem, 2019). In most cases, deposit banks have branches in other countries such as Turkey. The development and investment banks collect funds through individual current accounts. Amir (2016) pointed out that such institutions provide loans and other participating accounts with several branches all over the country. On the other hand, participation banks offer loans and other legally delegated functions. Other than creating and maintaining participation accounts, according to the Iraqi law, these private banks also accept deposits.

How Banks Generate Money

Brighi and Venturelli (2016) noted that Iraqi banks deploy various mechanisms to generate revenue and increase income. Some of these sources include trade-related activities, typical lending activities, as well as Treasury and CBI, deposits Iraqi banks, engage in importation and exportation of goods, which is a huge source of revenue. Further, the majority of small banks in Iraq offer loans with cash-credit to GDP at a paltry 9% compared to 55% within the Mena region. Al-Khero et al. (2019) further stated that banks which also maintain deposits to the Central Bank also earn income. The policy rate was one way of earning for many banks. Following the reduced inflation in 2008, the Central Bank of Iraq (CBI) also lowered the policy rate from more than 16% to 6% by 2011.

Banking Diversification and Bank Performance

Diversification is a useful strategy for protecting local banks against liquidity risk exposure in cases where the borrowing capacity is weakened, not cost-effective, or both. Similarly, Brahmana et al. (2018) found out that credit diversification lowers the probability of borrowers defaulting loans. In order to decrease the loan ratio of acquiring deposits from a specific source, deposit diversification can be realized. The source of deposit can be local or international and could be an individual, business, or the public sector.

According to Asif and Akhter (2019), reorienting customer deposits is another unique method of diversifying deposits. Further, offering certificates as backups for such deposits can also improve service diversification. There is a need to note that these are efforts aimed at improving the efficiency of banks borrowing, and thus reduce the overall weighted average cost of capital. Credit diversification processes, on the other hand, aim are lowering the probability of borrowers defaulting. The incentives which are out in place to cover such risk includes allocation of deposit and non-deposit borrowing funds to new customers in different geographical locations.

Similarly, Hamdi et al. (2017) explained that introducing a variety of credit facilities also reduces the risk associated with defaulting. The specialization of lending is another method of lowering the probability of loan defaults. Specialized lending is also attainable through

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reducing the diversification of various types of credit or diversity of customers who qualify for the loans. By increasing the weight of loans which do not attract higher interest, Saghi-Zedek (2016) suggested that banks can diversify their revenues. Increasing the various sources of loans that attract interest and those that do not attract interest improves the capital portfolio of the respective banks (Hashem, 2019).

Banks have a wider source of non-interest loans such as commission fees, investing heavily in money market instruments and earning revenue from specialized banking operations (Brahmana et al. (2018). Similarly, Sissy et al. (2017) argued that revenue concentration is another method of improving the quality of income-generating sources while lowering the dispersion of revenue. A lower revenue concentration is likely to debilitate the control of banks over more diverse banking activities and thus lowering their financial expertise. The consequences of these actions include increasing the direct and indirect costs and thus may reduce the competitive power of the respective bank. Contrarily, Khalili and Khalilpour (2016) posited that the increasing agency charges, the coincidence of bankruptcy and increasing diversity lowers the competitive advantage of the respective bank. Raeia et al. (2016) also posited that the investment portfolio diversification reduces instances of non-systematic risks by the allocation of finances over wider asset classes.

Portfolio diversification is also attainable through changing the investment strategy. In order to diversify the portfolio, banks should begin to successfully offset the systematic risks associated with the investment (Hamdi et al. 2017). There is a need to recognize that these types of risks are controllable. Typically, systematic risk is measured by the covariance between market returns and stock returns, which can be lowered by a decrease in the stock price volatility. Raeia et al. (2016) concluded that when earning fluctuations decrease, banks tend to achieve the diversity of services they offer.

Risk Management and Its Influence on the Performance of Banks

Previous findings suggest that the majority of financial institutions tend to grant loans to businesses, individuals, governments, or other entities. Brighi and Venturelli (2016) noted that a huge part of this profit results from business loans. A bank that cultivates a better relationship with its clients and employs various methods of assessing risk earn the trust and belief of their clients and perform better. Additionally, Brahmana et al. (2018) pointed out that for a bank to make a profit from its lending services, various measures have to be in place. The concept of loaning in the most crucial function of a banking institution.

The most significant share of the total revenues of the bank is generated from the earnings assets such as capital. Lending also represents one of the largest commitments of funds for many financial institutions that accept deposits. Banks which make the appropriate decisions, increase their profitability. On the other hand, institutions that make poor credit decisions are bound to fail or collapse in the long end. Similarly, Chai et al. (2016) also found out that profitability is the commonest methods of determining the success of a bank.

Methodology

Research Method and Design

In order to collect, analyze, and draw inferences from the findings of this research, a descriptive research design integrated with qualitative and quantitative research methods concurrently. Data was collected using close-ended questionnaires and further analyzed quantitatively.

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Sampling

A non-probability sampling technique was used to select the participants for this research. A purposive sampling technique was deployed. The researcher was interested in individual banks only within a specific geographical location. The respondents also fit the specific description of interest to the researcher. The research participants were employees and stakeholders of various banks within the Duhok region. The selected banks include Dasinya, Werkaa, Dastan, Sepe, Al-Shemal, Shemal, Gihan, and RT bank. The eight banks were selected because of their client diversity, which is a critical aspect of this research. The criteria were that the selected banks must be working six days a week and not less than 12 hours daily. The participants who displayed a proper understanding of the running of their respective banks were also eligible for this research.

N.	*Banks Name*	*Banks Assets Size $*	*Number of Employees*	*Location*
1	Dasinya	2,000,000	20	Duhok
2	Werkaa	1,500,000	16	Duhok
3	Dastan	1,700,000	12	Duhok
4	Sepe	850,000	15	Duhok
5	RT Bank	1,200,000	16	Duhok
6	Cihan	750,000	22	Duhok
7	Shemal	1,010,000	16	Duhok
8	Al-Shemal	1,000,000	22	Duhok

Data Collection

Since this research involves an integrated research method, primary data was required. The structured questionnaires included closed-ended questions that attempt to address the research questions. Upon completion, the questionnaires were returned to the researcher for analysis.

Data Analysis

The responses of the participants were recorded and tabulated for data analysis. The values were fed into the SPSS software for analysis and data output. The SPSS software also presented the outcomes of the analysis in tables for easier interpretation.

Discussion of the Results

In total, nineteen participants passed the eligibility criteria for this research and thus allowed to participate. There were 11 employees, five-unit leaders, two departmental leaders, and one entity director. More than half of the total respondents had achieved undergraduate degrees. Only three participants attained a postgraduate degree, while three others were high school graduates. There was a single respondent with other different academic credentials not included in the questionnaire. In terms of gender, there were 14 male and five female participants. Thirteen of the participants had more than six years of work experience. Three respondents had less than three years of work experience, while five of the research respondents had more than a decade of experience. The attributes of the research participants

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influenced the findings of this research. Table 1 below shows the characteristics of the respondents.

N.	Section's Parts	The Levels	Frequencies	
			F.	Total
1	Position Class	Employee	11	19
		Unit leader	5	
		Department Leader	2	
		Entity director	1	
2	Academic Degree	Secondary School	3	19
		Undergraduate	12	
		Postgraduate	3	
		Other	1	
3	Gender	Female	5	19
		Male	14	
4	Experience	Less than 3 years	3	19
		3 to 5 years	3	
		6 to 10 years	8	
		More than 10 years	5	

Table 1: The attributes of the selected participants

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	2.076	.729		2.848	.011
ZY	.525	.160	.622	3.272	.004

Table 2: Coefficients Table

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	.582	1	.582	10.708	.004[b]
Residual	.924	17	.054		
Total	1.507	18			

Table 3: ANOVA Table

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.622[a]	.386	.350	.233

Table 4: Model Summary

The variables were grouped into X and Y variables representing independent and dependent variables, respectively. The adjusted R square value is .386 (Table 4). This means that there is a 38.6% variation in the performance of the selected banks explained through the independent variables. The findings of the ANOVA represent the fitness model (Table 3). The p-value is 0.004 while the F value is 10.78. the essence of these values is that both the dependent and independent variable successfully met the criteria for the model accuracy. Normally, a p-value which is less or equal to 0.005 is statistically significant. Further, the value of the unstandardized beta coefficient is. 622. The value of the unstandardized beta

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coefficient means that for every single unit change, there is a 0.622 unit change in the performance of the banks (Table 2). Since the regression coefficients are statistically significant, the null hypothesis is rejected. In summary, the diversification of banking services positively affects the performance of the bank.

The diversity of banks services improves the performance of the bank. The weighted overall cost of the bank is likely to reduce because of credit diversification. The findings of this research are similar to those of Asif and Akhter (2019), who suggested that credit diversification not only lower the probability of defaulting loans but also allows the bank to invest in more than one sector. Previous studies suggested that banks that have engaged in specialized lending or loans with lower interest rates improve in their performance and build their credit portfolio in many ways (Saghi-Zedek, 2016). The results of this research have also replicated these findings by suggesting that widening the sources of earnings for many banks is an opportunity to create a more efficient credit capital, thus serving various sectors. The essence of diversity in banks is not only limited to improving the performance but also increasing their profit margins.

Brighi and Venturelli (2016) noted that banks which invest in money-making instruments and amass revenues from a wider range of sources are efficient. Further, the results of Sissy et al. (2017) suggested that concentrating revenue which is another form of diversification improves the quality of these income-generating sources. Banks are, therefore, likely to earn from a variety of sources, a result that is also replicated in the outcomes of this research. There is need to note that various money-making instruments define the diversity of services a bank offers. For example, offering international money exchange services is a huge money-making instrument that some banks do not invest. Conclusively, banks that adopt this type of service not only earn but also elevated their position within this sector.

Previously, Hamdi et al. (2017) argued that diversifying the portfolio of banks is attainable through offsetting the systematic risks of investments. The outcomes showed that systematic risk could be controlled due to the diversity and broad nature of services that banks offer. In agreement with the findings of this research, the reports of Al-Khero et al. (2019) revealed that diversifying the portfolio of the bank is beneficial in many ways. For example, lowering the fluctuations of earnings is possible through the diversity of the services a bank offers. The results of these previous research are in agreement with the main outcomes of this research, revealing that banks which offer a broad category of services, including diversifying their portfolio experience an improvement in their overall performance.

Conclusion

The diversification of bank services is positively related to its performance. Banks play a very vital role in the economy of a country. Some of these roles not only generate revenue for the government but also provide loans and financial services for the general public. The Central Bank of Iraq should take steps to ensure that the environment is favorable for the operation of banks. Decision making is an essential step in the diversification of banking services. Before a bank offers loans, various prerequisites have to be met. The credit risk of the lender and the probability of default are essential parameters to calculate in order to evaluate the status of a loan. Customers who may not be able to service their loans present a massive challenge to banks. The credit portfolio of the bank is likely to fall as a result of loan

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defaults. There is a need to recognize that the inherent challenges of lending to a single economy or set of clients also result from loan defaults.

Banks should, therefore, consider diversification in the view of clients and not only on the services on offer. A diversified market is a massive boost to the growth and development of a bank. Granting loans to clients from various backgrounds lower the risk of credit loss and increases earnings due to higher rates of interest. The basis of diversification is setting new foot into new markets or offering new services that will increase the number of clients. Many banks are seeking to increase the number of clients who seek their services as a method of improving their performance. The stakeholders and employees of a bank also play a vital role in the performance of the bank. These individuals provide the management of the bank with real-time data to evaluate the lending status of a customer.

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