How does the stock market value bank diversification?
Empirical evidence from Japan

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Abstract

This paper empirically examines the effect of functional diversification across different activities and loan diversification across different economic sectors on firm value and risk using stock market data. In the analyses, we focus on the Japanese banking sector, which is well known as a bank-centered financial system. We confirm the positive effect of functional diversification on the franchise values of banks, while there is no evidence that loan portfolio diversification increases the franchise values of banks. Furthermore, we find that a shift toward fee income–generating business decreases all types of risks (systematic risk, idiosyncratic risk, and total risk). On the other hand, we find that loan diversification increases banks' systematic risk, while it does not decrease idiosyncratic risk. Therefore, the stock market anticipates that Japanese banks can enjoy more benefit from functional diversification than from loan diversification.

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