Chapter 12
How Credit Portfolio Diversification Affects the Profitability of Vietnamese Commercial Banks

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ABSTRACT

This study analyzed the impact of credit portfolio diversification on the profitability by using the data of 20 Vietnam commercial banks from 2009 to 2015. The results from feasible generalized least squares (FGLS) estimation show that the strategy of diversifying the credit portfolio increased the profitability of commercial banks. In addition, the study also indicates that the positive correlation of the ratio of owners' equity, credit growth, liquidity, assets, inflation rate with the profitability while the increase in non-performing loan decreased the profitability of these commercial banks.

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INTRODUCTION

Since Vietnam became a member of the World Trade Organization, the country's economy has welcomed many opportunities as well as challenges to various economic sectors, including banking sector. On the one hand, opening the country's financial market creates many opportunities for Vietnamese commercial banks to attract foreign investment as well as to gain experience and advanced management capacity from several countries around the world. Increasing penetration of foreign banks also provides strong financial potential and professional management capabilities as well as raises pressure on domestic banks. Hence, all domestic commercial banks have to face the challenge of competitiveness and sustainable development or bankruptcy.

Credit supply plays an important role in private economic development. Along with the nation's development orientation, commercial banks have been developing a market share strategy to improve their competitiveness and serve the industrialization and modernization. On the other hand, due to high level of credit monopoly market, lending always account for a large proportion on the portfolio of Vietnamese commercial banks. In addition, the bank's main source of income mainly comes from lending activities. Therefore, the key issue for the banks in order to get high profits depends largely on lending accounts.

The above facts require a new research approach to detect and evaluate the impact of the structure of the credit portfolio on the operation of commercial banks. Various theoretical and empirical researches indicate that structure of credit portfolio by different economic sectors directly impacts on commercial banks' profitability. In particular, Bebczuk & Galindo (2008) and Rossi et al. (2009) showed that banks pursuit credit portfolio diversification strategy were able to increase profitability by taking advantage of economies of scale, minimizing operating costs, and targeting a wide range of customers. In addition, commercial banks were able to increase income from cross-selling operations such as salary payment, ATM card issuance, selling insurance, consulting and service fees. These products and services helped not only increasing banks' income but also achieving non-economic goals such as building and developing brands. Finally, allocating credit to a wide range of economic sectors less interdependent economic sectors helped commercial banks to be less interdependent and hence minimize losses and maintain stable profit for the commercial banks (Diamond, 1984).

However, many studies deny the benefits of bank's credit portfolio diversification strategy. According to Winton (1999), credit diversification increased the level of competition as well as caused serious consequences if commercial banks were not

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