

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

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ABSTRACT

Introduction - Credit risk related to commercial bank loans can be considered as one of the main risks faced by commercial banks. Therefore, commercial banks diversify their loan portfolio to improve performance and mitigate credit risk. Loan portfolio diversification refers to lending to different sectors without concentrating on a particular sector. The purpose of this study is to examine the impact of loan portfolio diversification on the performance of commercial banks in Sri Lanka.

Design/Methodology/Approach - Hirschman Herfindahl Index was used to measure the loan portfolio diversification and performance measured based on CAMEL model. Interest Rate Spread and Bank size considered as the control variables. Data were collected from audited annual financial statements of commercial banks for a 5-year period. Data were analysed by using correlation and fixed effect panel regression model.

Findings - The results reveal that there is a significant positive impact of loan portfolio diversification on commercial bank performance. Further, control variables bank size positively not significant links with commercial bank performance while interest rate spread has a negatively not significant impact on bank performance.

Conclusion - It is confirmed that a diversified loan portfolio position leads to the healthy performance of commercial banks. The management should follow specific strategies about loan portfolio diversification and improve commercial bank performance while making high attention about the loan portfolio position of the bank.

Keywords: *Credit Risk, Loan Portfolio Diversification, Loan Portfolio Concentration, Hirschman Herfindahl Index, Interest Rate Spread*