Прикладная эконометрика, 2024, т. 73, с. 59–77.
Applied Econometrics, 2024, v. 73, pp. 59–77.
DOI: 10.22394/1993-7601-2024-73-59-77

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Do non-interest income activities matter for banking sector efficiency? A net interest margin perspective

This paper explores the effects of non-interest income (NII) generating activities on banking sector efficiency in 152 countries from 1996 to 2017. Contrary to previous studies that examine the effects of diversification on banking performance at the micro-level, this study seeks to provide new insights about the effects of diversification at the aggregate level on bank efficiency. This aspect offers a chance to capture the whole banking sector and provides a broader understanding of the effects of banking sector diversification. Our baseline results reveal that engaging in NII activities is positively associated with banking sector efficiency. Using the dynamic threshold regression method, we do not find a tipping point beyond which the benefits of NII activities have an adverse impact on banking sector efficiency. These results are insensitive to different groups of countries. Our findings generally suggest that banking liberalization contributes to the efficiency of the banking sector. In this sense, the findings of this study support banking sector diversification policies implemented in many countries since the 1980s and 1990s.

Keywords: banks; net interest margin; non-interest income; bank profitability.
JEL classification: E40; G21.

1. Introduction

Banks function as financial intermediaries in the re-allocation of funds from surplus units to deficit units. Some economists, e.g. Levine (1997), have argued that an efficient banking system can provide low-cost monetary payments and effectively mobilize deposits and re-allocate funds to finance public and private investments and spur sustainable economic growth. To achieve this and following the advice of Bretton Woods institutions, over the past two decades, economic authorities in many countries have implemented financial sector reforms to liberalize financial markets and deregulate tightly controlled financial sectors. These reforms cover a wide range of sub-sectors, including insurance, banking, and stock markets. These changed the scope of bank activities in many countries enabling many banks to expand their business activities from traditional (loan-making) activities towards non-traditional financial services that generate commissions, fee income, trading revenue, and other kinds of non-interest income (NII). This diversification altered the income structure of the banking sector in many economies. NII now makes

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