Kwesi Bekoe Amissah-Arthur: Risk management in well-capitalized banks

Speech by Dr Kwesi Bekoe Amissah-Arthur, Governor of the Bank of Ghana, at the launch of the PricewaterhouseCoopers Ghana Banking Survey, Accra, 10 June 2010.

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Country Director and Staff of PriceWaterhouse Coopers (PwC),
Chief Executives of Banks,
Invited Guests,
Ladies and gentlemen

It is a pleasure to be part of the launch of the 2009 Banking Survey. The publication of the Survey is valuable and contributes to the process of providing a better appreciation of developments in our banking institutions. PwC deserves commendation for producing this document consistently over the last ten years.

I am told that investors have found it a useful source of information for making investment decisions; and in deciding which banks they should do business with. The methodology analyzes the published financial statements of banks (i.e. information already in the public domain) and draw conclusions based on parameters such as asset size, deposit liabilities, profitability and capital adequacy.

PriceWaterhouse Coopers gave me absolute liberty to choose my topic. Since we are launching a report on banking sector developments and performance, I have chosen to focus on the subject of risk management. From as far away as the United States of America we know the recent financial sector crisis originated from the sub-prime mortgage sector of the banking system. The impact has been felt around the globe and has left, in its wake, major financial institutions on their knees. The developments have affected hitherto remotely related economies and have left lessons for policy makers and bankers.

Not very far from here, Nigeria averted a major crisis in its banking sector in 2009, requiring the central bank injecting liquidity into a number of banks and installing turnaround management teams to steer these banks out of trouble.

What lessons are there to learn from financial crisis especially as we re-capitalize our banks to make them stronger and therefore better endowed for effective financial intermediation? Are well-capitalized banks necessarily a good thing, especially where this is not complemented by strong risk management?

I propose to share with you some perspectives on these issues.

Rationale for well-capitalized banks

The banking system has three major functions: taking deposits, making loans and investing in securities. Through its financial intermediation function, banks facilitate capital formation and promote economic growth. However, the ability of banks to engender economic growth and facilitate development depends on the health, soundness and stability of the system. The need for strong, well-capitalized and viable banks is underscored by the fact that the banking industry is one of the few sectors in which shareholders' funds are only a small proportion of the liabilities that banks hold. This, therefore, provides the necessity for the strong regulation of the banking sector.

As is well known in the country, in 2007 the Bank of Ghana determined new capital requirements for banks operating in the country.

Globally, size has become an ingredient for success. All things being equal, an enhanced capital-base should improve the competitive edge of a bank as it enables the bank to acquire appropriate, modern technology, engage suitably qualified personnel and capacity to absorb shocks. It also positions the bank to offer better value-added services more profitably.

There are many other benefits attached to the appropriate capitalization of the banking sector, and the Ghanaian banks stand to gain a lot from them. Some of these benefits are:

- Strong capital is a basic indication of solvency, and provides a good cushion against loss; an insurance against insolvency;
- Recapitalization provides an opportunity for eliminating weak banks from the system in an orderly manner;
- Well capitalized banks have better prospects for profitability and operational efficiency;
- Recapitalization provides an avenue for broadening the shareholder base of banks, especially through public listing, thereby improving prospects for good corporate governance;
- Well capitalized banks are better placed to finance the long term development needs of the Ghanaian economy and businesses; and
- Banks are able to invest more in training and development of manpower.

While there are potential upside benefits to be derived from well capitalized banks, there are equally downside risks, especially where risk management is not given the requisite attention. The activities of banks are inherently risky and capital is not a complete panacea for risk taking. Boards and senior management of banks must ensure that their risk appetite is held in check and that the quality of risk management practices is not compromised.

In this regard, risk management should not be a discussion confined to only senior level management. Risk management should be an enterprise-wide process, involving all levels. Top management is responsible for putting in place a well-defined risk governance framework and formulating the appropriate risk strategies. At the operational level, the roles of the business units are to ensure that key risks are appropriately identified, assessed and mitigated. Risk management is a dynamic and iterative process, not a one-off exercise. It is a continuous cycle; hence there should be genuine awareness, ownership and accountability for risks throughout the organization.

Lessons for banks from experiences elsewhere

There is no doubt that Ghanaian banks have many lessons to learn from developments in Nigeria and in the West. The first lesson is that poor risk analysis can have a debilitating effect on banking operations. Ignoring the dangers of credit, market, operational risks, even in a situation of high capital, can be problematic. Banking is not simply deposit mobilization and lending. Banking is about risk analysis and strategic deployment of funds to earn commensurate returns at minimal risk. It is not about bigger balance sheets or the fastest growing banks, although size and growth rate are important dynamics in banking.

An area Ghanaian banks will have to focus their attention is the need to increase their in-house capacity for risk analysis in the emerging oil and gas sectors. This is because the two sub-sectors that created problems for the five banks taken over by the Central Bank of Nigeria were in the oil and gas sector and the capital market (specifically margin loans). Incidentally the affected banks were opening their books to these sectors for the first time. Obviously, from the benefit of hindsight it is obvious that there was poor risk analysis of exposures to these sectors.

I have heard the suggestion that the banks lacked expertise in these areas. My response is that it is not enough to place the blame on the lack of expertise. Banks must invest in capacity building in risk management especially for emerging sectors of the Ghanaian economy.

As I suggested earlier, the culture of risk management is not well rooted in our banking system. Boards of banks need to establish Risk management functions at senior levels with direct reporting to a Committee of the Board to ensure that all risk aspects in the operations of banks are monitored and controlled. As banks in Ghana grow bigger and go international because of the capital injection, they are likely to take on several risks that they have previously been unfamiliar with. Banks' ability to manage cross border regulatory risks, currency risks, and other market risks will become critical going forward.

For banks to be effective in the new environment, they have to restructure their targets to reduce unnecessary risk taking, and reduce the motivation for fraud. Banks need to realize that high targets lead to higher risk taking which can result in higher profits but this may not necessarily result in better performance. Undue risk taking, buoyed by unrealistic targets or the wrong incentives, exposes depositors and creditors to unnecessary risk and can wipe out capital very rapidly. Banks should therefore evolve strategies to attain high performance within acceptable risk levels.

Lessons for the regulatory bodies

Did the regulatory bodies go to sleep while the Nigerian banks and their American counterparts went on the lending spree? I really do not think so although I believe that regulators could have done better. The implication is that this crisis may have been due more to a knowledge gap in the regulatory regime rather than lax regulation. Recently, Alan Greenspan, former Chairman of the Federal Reserve Board, noted that "you cannot legislate against greed, neither can you regulate greed". When greedy people see an opportunity to make money that looks "easy" it is difficult to stand in their way. This may be comforting but it does not relieve the regulator of the responsibility of being the "guard dog" of the public.

Regulators therefore have to sit up and become more proactive in the discharge of their regulatory functions. It is not enough to react to crisis; the aim must be to pre-empt them. The BoG is focused to deal with any potential crisis in the banking sector. We expect our counterparts, the Securities and Exchange Commission (SEC) and the National Insurance Commission to also re-position themselves for the challenges that lie ahead for a well capitalized financial system.

Association of Regulators

Conclusion

There is no doubt that the recapitalization programme is the right step to take by the BoG as this will make banks more resilient and thereby engender healthy competition among them. Re-capitalized banks also have the potential to accelerate the rate of economic growth and development of the country. However, to ensure that the synergy it promises is fully realized, and to mitigate post-recapitalization challenges, adequate steps should be taken to entrench good risk management practices in banks.

In conclusion, let us remind ourselves again that risk management is a corporate culture and everyone has a role to play in the process. The role of boards and senior management is critical in ensuring that the key risks, both present and foreseeable, are identified and effectively mitigated. With concerted efforts from all parties, an effective risk management process will enable banks to minimize financial losses, and optimize business practices, in order to respond to the changing business environment.

Thank you all for the attention.