Millison Narh: Ghana's financial services industry and its impact on private sector growth

Keynote address by Mr Millison Narh, First Deputy Governor of the Bank of Ghana, at the Ghana Association of Bankers – 13th Annual Working Luncheon, Accra, 8 August 2013.

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Mr. Chairman, the Executive Secretary, Members of the General Council, Managing Directors of Banks, Fellows and Associates of the Association of Bankers, Members of the Banking Fraternity, Distinguished Guests, Ladies and Gentlemen:

1. Good afternoon and welcome to the 13th Annual working luncheon of the Ghana Association of Bankers. I am privileged to be given the opportunity to address stakeholders of the banking sector today. The Association gave me the liberty to decide on any topic and since this gathering consists of members of the banking fraternity, I have chosen to focus on the financial services industry and its impact on private sector growth, with emphasis on financing small and medium term enterprises. But first, let me start with the current global and domestic economic conditions through which we can leverage our way, as financial intermediaries to promote growth and development.

2. Mr. Chairman, we are holding this annual luncheon against the backdrop of continued global uncertainties characterised by financial and sovereign debt crisis in the euro area and weakened global growth prospects across major advanced economies. The prevailing weak global economic conditions have dampened external trade and weakened commodity prices on international markets. In the first half year of 2013, we have seen some signs of growth though unevenly spread across regions. In the euro area, the recession continued and in the US, the recovery remained timid while Japan offered some positive signs of growth. In emerging markets especially China, the tempo of economic activity has reduced somewhat, posing further threats to overall global growth prospects.

3. In the quarters ahead, however, global growth is projected to pick up gradually while an upturn in world trade and financing conditions may also boost growth in the euro area. These notwithstanding, the impact of the current weak global conditions have resulted in sharp drop in commodity prices, especially gold, with adverse implications for the country's external sector. Mr. Chairman, let me now shift focus to developments in the Ghanaian economy over the first half year.

4. The Ghanaian economy experienced phenomenal growth over the last two years, spurred on by the oil sector and its multiplier effects on economic activity. Economic growth peaked at 15 pct in 2011 and 8 pct in 2012 with inflation firmly anchored in single digits for the two consecutive years. However, assessment of current economic conditions in the first half of 2013 indicates some growth moderation amid rising inflation.

5. Economic conditions broadly remained challenging during the first half of 2013. The developments reflected a slower pace of real sector economic activity during Q1 evidenced by a contraction in the real CIEA and weak business and consumer sentiments in the quarter. However, economic activity and consumer confidence rebounded in Q2 while business confidence continued to be weak.

6. Headline inflation has consistently trended upwards in the year on account of significant increases in domestic petroleum products and seasonal food cycle which affects prices. Inflation has risen to 11.8 pct in July 2013 (new CPI basket), from 8.8 pct in December 2012. In addition, inflation expectations by both businesses and consumers remained heightened.

7. On the external front, prices of Ghana's key commodities softened which resulted in lower export earnings. This, coupled with moderated import growth, resulted in some

improvement in the trade deficit to US$1.2 billion in the first half, compared with a deficit of US$1.3 billion same period last year.

8. While modest gains have been made in broadly stabilizing the foreign exchange market, major vulnerabilities emanating from continuing imbalance in the supply and demand conditions on the market are currently exerting some pressure on the local currency. On a year to date basis, the Ghana cedi has cumulatively depreciated by 3.4 pct against the US dollar, compared to 17.2 pct depreciation a year earlier. Going forward, the Bank of Ghana stands ready to implement both short term and medium to long term measures to ensure stability in the foreign exchange market.

9. Mr. Chairman, as we all know, developments in the banking sector showed that banks remained profitable, liquid and well-capitalised, thanks largely to the high interest rate environment that has persisted for some time now. In contrast to low investment yields of 2 pct in global financial markets, banks in Ghana on average had ROE of over 20 percent and ROAs of over 5 percent. The Capital Adequacy Ratio (CAR) was about 18 pct, above the prudential limit of 10 pct. Asset penetration, measured as the ratio of total assets to GDP, was 40.5 pct indicating continued deepening of the financial sector in the economy.

10. These notwithstanding, there are some concerns to us at the Bank of Ghana like the persistently high level of NPL ratios compared to other peer countries. As at June 2013, the NPL ratio was 12.8, down from 13.2 in June 2012. Although the rates are on the downward trend, they are still high and we are taking steps to encourage banks to write-off long outstanding "loss" accounts with 100% provisioning that tend to overstate the true NPL level. For instance, when we account for the loss category, the NPL ratio as at June 2013, declined to 4.7 which compares favourably with prevailing NPL levels in other peer countries.

11. On the other hand, there is also the need to apply strict provisioning rules on overdraft facilities which are more prone to "ever-greening" than ordinary term loans. Other issues are: the build-up of unclaimed deposit balances or dormant accounts on banks' books; concentration risk on both sides of the balance sheet – large loan exposures and reliance on large deposits; the need for transparent regulatory issuances on such issues as Mergers & Acquisitions, internal controls, and external auditors; and finally the need to update manual of accounts and reposting requirements.

12. The Bank of Ghana took another major step to enhance transparency in the setting of lending rates in the industry. The new base rate model which seeks to ensure transparency and uniformity in loan pricing within the banking industry, became operational in July 2013. As per the directive, banks have fully complied with the new framework and there are positive indications that on the average, base rates have declined by about 3 pct in the banking industry. This new initiative, together with the credit bureau system and the collateral registry should help improve the environment for lending and further help lower NPLs in the banking industry.

13. Mr. Chairman, permit me to touch on a matter that is sensitive to both the industry players and the Bank of Ghana that is capital requirements. Developments in the macro-economic front have necessitated the need for the Bank of Ghana to review the minimum capital requirements for ***new industry entrants***. In this regard, the minimum paid-capital for major banks have been revised from GH¢60 million to GH¢120.0 million while that of NBFIs increases from GH¢7.0 million to GH¢15.0 million. That of the rural banks have been upped to GH¢300,000.

14. These increases are necessary in order to provide our institutions with the muscle to undertake big-ticket deals to support the growth of the private sector and to further serve as a capital cushion for absorbing unexpected losses that may arise in the normal course of business. In this regard, I would like to take this opportunity to advise the industry players, particularly the banks, to properly align their risk appetite to their capital levels. This is important because any misalignment between risk and capital could threaten the solvency of the institution and unduly put shareholders investments at risk. Mr. Chairman, subsequent to

these capital enhancements, we have initiated action towards gazetting the increases as required by law.

15. Mr. Chairman, to equip our tool box with the necessary tools needed to identify and manage problem banks, the Bank of Ghana has developed a Supervisory Intervention Guide which seeks to provide a consistent and transparent framework for intervening in the operations of regulated deposit-taking Financial Institutions with the view to protecting the interest of depositors and shareholders.

16. In order to further strengthen the regulatory and supervisory regime, we have also developed guidelines and regulations which are being fine-tuned for the consideration of the sector minister and Parliamentary approval where necessary. These include;

- Corporate Governance Regulations
- Licensing Regulations
- Outsourcing Guidelines
- Risk Management Guidelines
- External Auditors Regulations
- Mergers and Acquisition Guidelines

17. Of these, the Outsourcing Guidelines and the Corporate Governance Regulations have already been exposed to industry and we have received contributions and some interesting comments from the banks. It is evident that without a strong Corporate Governance regime, shareholder's investments will be put at risks and the industry as a whole would be less attractive to investors.

18. Mr. Chairman, to further strengthen our supervisory function, the Bank of Ghana has also initiated action toward the revision and consolidation of the existing laws that govern the Banking and Non-Bank Financial Institutions. It is envisaged that these initiatives would remove any potential vulnerabilities in the banking landscape to ensure a safe and sound banking practices across the industry.

19. Another recent industry development is BOG's quest to introduce a Deposit Insurance Scheme in Ghana. Pursuant to this objective, a feasibility study has been done by Global Business Solutions of Germany, financed by KFW of Germany. The study has since been approved by the Bank of Ghana, KFW and the Government of Ghana (GOG) through the Ministry of Finance. Currently the Bank of Ghana and the Ministry of Finance have reviewed and approved the Terms of Reference for the Legal consultants to draft a Deposit Insurance law for industry. It is our expectation that the Deposit Insurance Agency would become operational by end December 2014 and that could afford some protection to all depositors.

20. The key challenge going forward to the banking industry is how to maintain the continued high levels of profitability over the medium to longer-term and more particularly, when the interest rate environment begins to shift its course. It appears to us at the Bank of Ghana that, among many other avenues for maintaining the bottom line like massive cost cutting and growing non-fee-based income, the answer could lie in taking up the SME challenge – which in the words of a recent banking survey means harnessing the SME potential.

21. Although the banking sector has not witnessed new entrants this year, the number of microfinance institutions licensed by the Bank of Ghana has more than doubled to 228 by June 2013, from 90 in December 2012. The increasing trend in acquisition of licenses by microfinance institutions signals the increasing demand by economic agents at the lower echelon of financial service provision.

22. Traditionally, banks are known to focus largely on corporate as well as personal and consumer banking. Thus, the increasing number of microfinance institutions suggests a broadening of the scope of financial service provision at the micro level. This leaves a wide financial services gap, which has been referred to as the “missing middle” and constitutes mainly Small and Medium Enterprises (SMEs).

23. Mr. Chairman, the critical role that this segment of society plays in any economy cannot be overemphasised. Various studies show that promoting the development of SMEs can be used as a catalyst for economic growth, employment and poverty reduction. And yet, by their nature, SMEs are constrained from accessing financial services, especially through the major banks due to lack of proper governance, weak management systems, technical knowledge, and poor labour skills. Although most banks are aware of the potentials of SMEs, venturing into the sector requires painstaking efforts to help them overcome these constraints. Nevertheless, SME financing can be a good business for banks and a better understanding of the sector should provide enough incentives for banks to start and build business relationships with them. This is an investment that can be done now within the environment of high bank profitability.

24. To start with, it is important for banks to understand the mode of operation of SMEs and develop innovative financial services that suit those peculiar needs. Typically, SMEs have weak competencies in financial management and they operate with low levels of productive capital which heightens their risk levels. With such background knowledge, banks should seek to set up specialised desks to provide strong guidance for SMEs to address weaknesses in their financial management, handle SMEs appraisals, loan documentation and monitoring. These processes could set very high standards for SMEs financing and help lower risks associated with the financing sector.

25. While it is essential for banks to embrace SME financing, it is even more critical not to downplay the risks associated with the sector. This brings up the issue of risk management systems and structures to assist in the identification and effective management of risks in the banking environment, including that of SME banking businesses.

26. The need to invest in risk management structures, policies and procedures including IT systems that go beyond the traditional lending activities of the bank to include SMEs should therefore be factored in as banks engage in their own internal capital adequacy assessment program. Some profits could be retained to support such SME-friendly capacity-building initiatives in addition to funding internal growth to meet the demands for large financing by our fast-growing oil economy. In addition, the practice of placing some funds with banks abroad beyond usual need to fund correspondent banking relationship should be rationalized by banks heavily engaged in this practice.

27. We are also closely monitoring the fast growing share of deposit – taking non-bank financial institutions (NBFIs) sector such as savings and loans companies and finance houses in the total assets of the financial system. The strong growth of these other institutions has reduced the banks share in total assets from 89 pct in 2010 down to 85 pct. These smaller institutions which are able to offer more competitive rates on deposit products to their customers are inching up their market share. Clearly, this development should be a wakeup call to all banks since there are more funds that can be intermediated in the economy if the price is right.

28. In conclusion, let me reiterate that financial intermediation, especially for SMEs, is critical for overall private sector development and growth acceleration. However, it is important to create the necessary macroeconomic environment for an effective and efficient financial sector to jumpstart the process. Looking ahead, the central bank is optimistic that inflation will edge closer within the target band by end year as inflationary pressures decline in the quarters ahead. The Bank also stands ready to implement sound monetary policies and take appropriate measures aimed at consolidating macroeconomic stability.

29. Thank you for the attention.