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RISK MANAGEMENT TERM PAPER

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TOPIC CHOSEN: WHAT IS YOUR ASSESSMENT OF THE SAFETY AND SOUNDNESS OF YOUR COUNTRY'S BANKING SECTOR?

ASSESSMENT OF THE SAFETY AND SOUNDNESS OF GHANA'S BANKING SECTOR.

Introduction

The main essence of this paper is to make an assessment of the safety and soundness of the banking sector in Ghana. This analysis will be done, focusing mainly on the current state of the sector and its pitfalls or improvements over the past few years. I will be making a brief introduction of the Bank of Ghana as well as give a short history on the evolution of the banking sector in the country. My assessment will mainly be based on the reports published by the Bank of Ghana also known as the Central Bank as well as guidance from the Financial Sector Assessment Program Report by the International Monetary Fund on the Financial System Stability Assessment published in 2011. This assessment will also shed more light into the recent challenges of the sector and the steps taken by the regulatory bodies to solve those problems as well as improve the sector. My ultimate opinion will focus on the degree of safety and soundness of the country's banking sector.

The banking sector in Ghana is regulated by the Bank of Ghana (BoG). The BoG has the overall supervisory and regulatory authority in all matters relating to banking as well as non-banking financial businesses with the main purpose of achieving a sound and efficient banking system in the interest of the people and the economy as a whole. The sector is regulated by the Bank of Ghana Act 2002, Act 612, Banking Act, 2004(Act 673). The Bank of Ghana is charged with the responsibility of ensuring that the financial system is stable and that it serves as a conduit for wealth creation, economic growth and development.

A Brief History on the Banking Sector.

The Bank of Gold Coast was set up in 1953 by the then government. As time went on, it was split into two, one being the Bank of Ghana which was to be developed into a complete Central Bank and the second being the Ghana Commercial Bank, which was to be developed into the largest commercial bank with a monopoly on the accounts of public corporations in the country. The Bank of Ghana assumed the responsibility of managing the currency, and issued the first national currency in July 1958. The currency issued was the Cedi to replace the old West African currency notes. The Ghana Commercial Bank began to take over the finances of most of the government departments and public corporations. The dawn of a new government in 1957 saw the establishment of more banks. Some of the banks incorporated during this period to 1965 are; The Ghana Investment Bank, to serve as an Investment Banking Institution, The Agricultural

Development Bank, for agricultural purposes, The Merchant \bank, and the Social Security Bank to encourage savings in the country. In accordance with the economic policy during that time, all these banks were incorporated as state-owned banks. The Banking Law was enacted in 1989 and this enabled suitable local institutions to file for applications to obtain licenses to operate as banking institutions. As time went on, a number of entities were licensed to operate as banks, including CAL Merchant Bank, ECOBANK, Trust Bank among others.

The Current State of the Banking Sector.

Public Confidence and security in the banking system is paramount to the success of the overall banking sector and the economy as a whole. The public's trust in the system and the operations of the sector is necessary to maintain the primary funding sources to enable the sector and the individual banking institutions meet their objectives. The implementation of safe and sound practices is essential in meeting this. The banking sector in Ghana has experienced a rapid growth especially in the last decade. The sector has undergone swift changes and major structural transformation, which has brought new opportunities as well as risks. In the years leading to this, the financial system remained relatively underdeveloped, with focus mainly on the banking sector.

It is worth noting that, the banking sector in Ghana is dominated by foreign-owned banks. Of the 26 commercial banks operating in the country, 13 are subsidiaries of foreign banks. The state also has a controlling interest in five commercial banks through both direct and indirect shareholdings. Through these stakes, the Bank of Ghana has both the roles of a shareholder and a regulator. The main point of stating this is to assess how the increase in government's dominance in the sector further increases the vulnerabilities and risks prevalent in the banking sector. Both roles played by the Bank of Ghana as both a shareholder in some commercial banks and an ultimate regulator of the sector can create instances of conflict of interest as well as undermine supervision. According to the IMF's report published in 2011 on the assessment of the financial system in Ghana, it was stated that the performance of the state-owned banks was poor, due to lending practices that were focused on developmental objectives at the expense of prudential considerations. The losses of these banks have also created contingent liabilities for the government. The government intervention and its accumulation of arrears had created a situation of Non-performing loans (NPL) across the country. It was estimated that the issue of NPLs contributed to about 46% of government arrears. This issue of NPLs would be further assessed in the era of the banking crisis in subsequent years. Commercial banks were highly exposed to credit risk, since it has grown in an environment of weak credit risk management. In addition to this, banks were increasingly lending to their employees, resulting in high lending rates that responded slowly to changes in the policy rate.

Despite these problems and setbacks in the sector, the Bank of Ghana and governments took steps by creating pragmatic policies that have been significant in the improvement of the sector. In line with the government of Ghana establishment of the Divestiture Implementation Committee to implement and execute all government policies in respect of this divestiture program, government began to prioritize some of the state owned banks and the liberalization of the banking sector. These new policies led to the entry of a number of banks and enhanced competition and efficiency in the sector. The increase in the number of banks also resulted in the increase of the minimum capital requirement from GHS 60million in 2007 to GHS 100million in 2013. An increase in the minimum capital requirement implied that the barrier for entry and exit into the industry were stricter and stiffer, and the net effect was to be a reduction in the number of banks as well as increase the level of competition.

In my opinion, the increase in the level of competition has improved banking services and deepened the level of delivery of those services by the various banks. It has awakened the spirit of innovations as seen in the provisions of the state of the art Automated Teller Machines (ATMs), electronic banking, telephone banking, SMS banking among others. These have contributed positively to the profitability of the sector. Mensah (2014), in his study of the impact of electronic banking on the profitability of banks in Ghana, especially the Agricultural Development Bank discovered that there was a significant increase in the net profit margin of the bank in the year 2011 when e-banking was introduced concluding that e-banking had a positive effect on profitability of the banks. Customers feel the need to embrace the electronic banking as it poses a level of security and safety of transactions rather than physically going to the bank to undertake a transaction. Despite the operational risks posed to the banks by the introduction of this, the strategies intended for its inception were fulfilled and beneficial to the security of the banks.

Recent Events and the Banking Crisis.

The glory days of the sector albeit not all glorious but improved can be said to have been short-lived as in recent years past, the sector has taken a nose dive into its worst state yet. In the last four years, the banking sector has been experiencing some financial setbacks and turmoil which led to the banking crisis. The banking crisis in Ghana was the most severe banking and economic crisis that affected the country and took place between August 2017 and January 2019. The Bank of Ghana allowed several local banks in the country to be taken over by private companies after a new government was elected into power in 2016. The banking sector has recently been in the news for all the bad reasons. It all started with the announcement of the Bank of Ghana to increase the minimum capital requirement for the banks from GHS 120million to GHS 400million in 2017. This recapitalization of the sector was a major factor in triggering the crisis as well as the number of banks which were in existence at the time. Some analysts pointed out that 35 banks in the country was too high for a population of just 27million as compared to a country like Nigeria which has a far larger population of almost 200 million but with only 27 banks. The sector has been hit with the crisis since the inception of the recapitalization program in 2017 which has seen a number of banks go under and acquired by others or merged. When it became glaringly evident that a number of the newly launched particularly local banks could not meet the new capital obligation by the end of 2018 as announced by the Bank of Ghana, the BoG was forced to take rigorous actions against such banks. To be specific, UT Bank and Capital Bank became the first casualties after their licenses were revoked. The Bank of Ghana subsequently selected GCB Bank which is the largest bank to acquire the deposits, certain assets and liabilities of both failed banks. The Bank of Ghana state that both banks were "heavily deficient in capital and liquidity, and their continuous operation exposed the financial system to instability and depositors' funds to risks". They were described as deeply insolvent. This led to instability and panic in the sector.

Without the dusk settling on this massive hit, a year later saw the consolidation of five banks; Beige, Sovereign, Construction, UniBank and Royal Bank into a new institution called the Consolidated Bank of Ghana. The main reason also being the insolvency challenges facing them. The shocking part of the situation was that some of these banks were granted their licenses as recent as 2016-2017. Which begs the question of the efforts of the Bank of Ghana in conducting its reviews and as to how the financial, operational and governance failings in these banks were allowed to persist. An investigation into the issue revealed that some officials misappropriated some liquidity support given to some of the banks by the Central Bank.

Some of the major reasons cited as the factors which accounted for the crisis were the high levels of NPLs in the sector. According to the BoG, the banking sector assets remained a major concern as the stock of NPLs in the banks and the ratio of NPLs remained high. It was observed that most of the collapsed banks had huge NPLs on their balance sheets. NPLs adversely affected the banks in ways such as increased operating costs, which led to a reduction in profitability levels. This caused capital reduction which led to undercapitalization. Another major reason cited was poor corporate governance. This was specifically stated by the Bank of Ghana and other financial analysts as a major reason which drove the banks under. Board level and senior management were either inactive or engaged in activities that saw to their personal interests rather than the growth of the banks. An observation was that most of the NPLs were advanced to people who were somehow related to the senior board managers. In addition, the Board of Directors failed to oversee bank accounting and corporate reporting systems as well as the external auditing systems due to lack of experience or greed. They failed to provide proper risk management frameworks. The general non-adherence to policies of corporate governance has greatly contributed to the collapse. It was also alleged that there were too much instances in the local banks to pick loans without any recourse to paying back or following appropriate policies. Appropriate risk management practices to reduce credit risks were no observed. The Bank of Ghana stated that regulatory non-compliance, and poor supervision lead to a significant build-up of vulnerabilities in the banking sector. The backlash of this was an increase in panic withdrawals all over the country and a spike in the unemployment rate.

Safety and Soundness of the Sector.

The safety and soundness regulations ensures that banks operate in a safe and sound manner and do not pose excessive threat to its depositors. This cannot be said to be the case in the country. However, the speed and efficiency with which the Bank of Ghana took to avert the deep implications of the recent state of the sector and its swift response to the crisis by way of several remedial measures implemented has been applauded by analysts and other industry players. The thorough assessment into the state of the sector and the banking crisis is to enable an understanding into the recent implementations of the Bank of Ghana in strengthening the safety and security of the banks. In a report given by the Bank of Ghana, it stated that the banking industry remains safe and sound despite all its weakness. Banks were generally solvent and sufficiently liquid by the end of the crisis. The Central Bank continued its recapitalization efforts. On the supervision front, the Bank of Ghana continued to put in extra measures to address weaknesses in the banking sector. These included the issuance of the Capital Requirements Directive towards the implementation of Basel II/III in the banking sector as well as financial holding company directives to address corporate governance issues currently facing the banking sector. The Bank of Ghana report stated that key financial soundness indicators have moderately improved. The financial soundness of the sector was enhanced during the period, which was evidenced by the improvement in the key indicators.

- Capital Adequacy Ratio(CAR): The banking sector remained resilient and robust which was evidenced by its improved solvency even under the more stringent Basel II/III framework. The ratio has remained well above 13 percent buffer since the introduction of the framework, pointing to the sector's improved ability to withstand losses following the reforms and the recapitalization.
- Profitability: The banking sector posted stronger profits during the following months after the crisis, which translated into improved profitability indicators. The net income recorded an annual growth of 38.8 percent in the early period of 2020 as compared to the growth of 31.5 percent in the previous year.
- Operational Efficiency: The sector remained efficient up to date with significant improvement in key efficiency indicator. The sector's cost to income ratio improved to 76.5 percent in February 2020 from 79.4 percent in the same period of the previous year, while the costs to total assets increased marginally 7.7 percent as compared to 7.5 percent in the previous year.

Despite the strong performance of the banking sector, the potential impact of the COVID-19 pandemic indicates that the operations of banks may face the challenges of credit extension, loan repayment. To help mitigate such effects, the Bank of Ghana announced policy measures to boost financial intermediation while minimizing the risk of deterioration in asset quality. The Bank of Ghana continued to monitor on-going developments to ensure the safety and soundness of the overall sector.

Conclusion.

In my opinion, the banking sector has a long way to go in solidifying its safety and soundness, which is evidenced by the continued lack of trust in the banks by the citizens. For example, the Bank of Ghana announced an increase in fraud cases of 2,295 in 2019 as compared to 2,175 cases reported in 2018, and security issues such as this are only to mention a few. Looking at performance however, I believe the sector has revealed strong growth through improved financial soundness indicators which further cemented the stability of the sector. The major risk currently is the continued impact of the COVID-19 pandemic, but I believe the proactive measures which were announced by the Central Bank should help in the mitigation of such risks.

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