

BUILDING A FINANCIAL SECTOR FOR AN EMERGING MARKET ECONOMY

IMPLICATIONS FOR THE CAPITALIZATION OF BANK AND NON-BANK FINANCIAL INSTITUTIONS

Bank of Ghana Consultation Paper

October 2007

1. As with most developing countries that have pursued economic and structural reforms, Ghana has been undergoing a process of financial sector restructuring and transformation as an integral part of a comprehensive program for some time.

2. The financial sector reform is a critical part of the country's strategy to achieving emerging market status. In this regard, several reforms are taking place to enable the financial sector world first class services within a the globalized financial system.

3. Financial sector policy conducted through the licensing of banks sought to serve multiple objectives other than the fundamental goal of debt and equity intermediation, these were (a) to develop specialized segments of banking and financial services notably merchant banking, development banking, retail banking, mortgage banking, and rural-based banking and finance institutions, (b) to develop national and local entrepreneurs and the participation in the sector through the use of differentiation of levels of capitalisation and equity requirements, and to source strategic national interest, more generally, by way of direct state ownership and intervention in banking activity, including extending banking services to achieve regional balance and equity.

4. The financial system that has emerged is relatively diversified in the range of services and increasingly innovative new products. While small and medium sized private enterprises depend extensively on self-financed capital investments, the economy is dominated primarily by bank-intermediated debt finance. The next stage and the thrust of financial market policy is developing

a vibrant capital market as a vehicle for raising funds to support large amounts of equity finance and investment.

5. The reforms moved the financial sector from a regime characterised by controls to a market-based regime. The reforms liberalized controls on interest rates and bank credit. The central bank, the bank of Ghana shifted gradually from a direct system of monetary controls to an indirect system that utilized market-based policy instruments.

6. As part of the process, the Bank of Ghana rationalized the minimum reserve requirements for banks, introduced new financial instruments, and open market operations for liquidity management. The Banking Act empowered the central bank to complement these policies by improving the soundness of the banking system, the regulatory framework, and strengthening banking supervision, and improving the efficiency and profitability of banks, including the replacement of their non-performing assets. The shift by the Bank of Ghana towards risk-based supervision is a signal of preparations towards implementing the Basel II objectives.

7. Liberalizing entry and encouraging foreign banks and investors in the financial services industry has increased competition in the banking industry as well as the introduction of strong business practices, technology, products, and risk management systems.

8. The entry of foreign banks of international standing surely mitigates the anti-competitive disadvantages inherent in concentration and enhanced market power of domestic banks, giving impetus to dynamic efficiency.

9. Recent developments in Ghana's banking environment point to the strong foundations for sustainable growth, such as a macroeconomic policy geared towards stability and a structural policy geared towards growth and a sound financial sector.

10. As part of the process of liberalization, the Bank of Ghana introduced “universal banking” in the first quarter of 2003. Universal banking allows banks to undertake, commercial, development, investment or merchant banking without the need for separate licences. This development, however, is related to one’s capital resources as one would be assuming more risks with the expected expansion and so the need to be well resourced to do so.

11. A dynamic growth-oriented financial system must be underpinned by an efficient payment and settlement system. Ghana is still essentially a cash-based economy with embedded high transaction costs. It is therefore important that we move towards more efficient payment methods like cheques and electronic cards. In recognition of this, the Bank of Ghana is undertaking reforms in the legal, institutional, and infrastructure framework of the payments system to make the Ghanaian financial system modern and competitive.

12. Driven by these objectives, the Bank of Ghana is pursuing a major overhaul and modernization of Ghana’s payments and settlement system infrastructure. As part of this process the Bank has implemented the Real Time Gross Settlement System (RTGS) for high-value payments. The RTGS has created an enabling environment for safe, sound, secure, and timely payments. It has also reduced systemic, payments and settlement risks as payment orders are settled almost instantaneously. To complement the RTGS, the Bank of Ghana also introduced a paper-based credit clearing system this year to facilitate the settlement of low-value payments, with plans to migrate these settlements to an electronic platform in the near future.

13. The Bank of Ghana is also establishing a National Switch (E-ZWICH) to allow the establishment of a common platform for all payments transactions in the country. This would result in the integration of all existing bank switches and allow banks that do not have switches (e.g. ARB Apex Bank) to join the common switch at significantly reduced costs. It would also allow the interoperability of all ATMs and the settlement of payments transactions by customers of different banks at Points of Sale (POS). The national Switch will

have the capability to deal with transactions that take place online (in places with telecommunications) and offline (i.e. where telecommunications are not present, e.g. in some rural areas). This is a major departure from existing systems and has been made possible by the Universal Electronic Payments (UEPS) technology.

14. Furthermore the Bank of Ghana, is also introducing a National Biometric Smartcard (The E-ZWICH card) as a major vehicle for financial inclusion. The Biometric smartcard will address the shortcomings of existing debit cards which cater to only a small fraction of the population because of its features of accessibility; low transaction costs; limited infrastructure needs; personal safety; security; convenience; and simplicity.

15. In addition to the National Switch and Smartcard, the Bank of Ghana is introducing Codeline Cheque Truncation to allow very fast cheque clearing as well as the Automated Clearing House (ACH) for the clearing of electronic debits and credits. For example, the process of direct debit does not exist presently in Ghana because of the absence of an ACH.

16. All these systems are expected to come online by the end of June 2008.

17. As part of the infrastructure necessary for capital market development, the Bank of Ghana has also established a Central Securities Depository (CSD).

18. The new central securities depository will make it possible for records of ownership of individual securities to be maintained centrally as well as at the respective primary dealers. This should reduce the risks to investors that arise from possible poor record-keeping or any dealer malfeasance. Eventually, the system will also be extended to include other fixed-income securities as well as equity securities listed on the Ghana Stock Exchange.

19. The Central Securities Depository has the capacity to bring together in one location securities listed on the Ghana Stock Exchange, over the counter securities, Government securities, mutual funds and unit trusts. It would enable securities to be held and processed electronically by book entry.

20. The CSD will make it easier to trade in securities. For example, it will enable an investor to rediscount a security with a dealer other than the one through which the security was first purchased, and transfer that security to any dealer willing to pay the highest price for that security.

21. In sum, the new central securities depository constitutes an important step in developing a secondary and liquid market for government debt instruments and other securities and it should put a hard-wire around the capital market infrastructure to improve security and investor confidence.

22. Along with these initiatives, the Bank of Ghana has introduced a number of reforms in the wholesale market for Government Securities, including a primary dealers code of conduct. These reforms together should bring to the domestic financial market increased efficiency and transparency, reduce transaction costs, and ensure broad-based participation of individuals on both competitive and non-competitive basis with greater security of title.

23. In putting together such a comprehensive payments and settlement system infrastructure the issue of management and protection of such major investments has become important. It is for this reason it has been decided to bring all the various aspects of the payments system infrastructure under a single entity, **the Ghana Interbank Payments and Settlement System (GHIPSS)** a limited liability company to allow more efficient and coherent management and oversight.

24. The business of GHIPSS would include the following:

- National Switch and Smart Card Services
- Cheque Clearing
- Codeline Cheque Truncation
- Real Time Gross Settlement System (RTGS)
- Central Securities Depository (CSD)
- Automated Clearing House (ACH)

25. All banks are required to be members of GHIPSS either directly or through member banks. This means that all banks have to be members of the national switch and smartcard, ACH, RTGS, etc.

26. To enhance credit risk management by the banking system the Credit Reporting Act (Act 726) has been enacted. The purpose of the Act is to provide a legal and regulatory framework for credit reporting in Ghana. The availability of credit information is generally accepted to be crucial for the development and maintenance of an effective financial sector. Since borrowers tend to have a natural incentive not to reveal negative information about themselves, the problem of information asymmetry arises which exposes the financial system as a whole to great risks. This Credit Reporting Act is designed to promote the orderly development of a credit reporting system for Ghana and to promote public trust in credit bureau operations.

27. The Foreign Exchange Act (Act 723) has been enacted to replace the Exchange Control Act, 1961. This marks another milestone in deepening the financial system. This Act, which provides a new statutory framework for foreign exchange payments and transactions, became law on 29th December 2006. Broadly, there is a shift away from the controls embodied in the Exchange Control Act to monitoring foreign exchange transactions for balance of payments and other purposes. In this regard, and consistent with international best practice, banks will be required to submit reports on all underlying transactions in foreign exchange to the Bank of Ghana.

28. While the Exchange Control Act placed restrictions on the issuance and transfer of securities as well as external loans contracted between residents and non residents, under the Foreign Exchange Act, 2006 there is a liberalization of inflows of foreign exchange into Ghana for foreign direct investment purposes. Also loans contracted by residents will no longer require Bank of Ghana approval. Non-residents are now permitted to invest in money market instruments of a tenor of three years or more. The restrictions on foreign holdings of equities listed on the Ghana Stock Exchange have also been lifted.

29. Several bills have already been passed or are in the process of being prepared. These include the Anti-Money Laundering Bill, the Credit Union Bill, the Insurance Bill, a new Insolvency Bill (Bankruptcy law) and revision of the Companies' Code. Work is also ongoing regarding the Borrowers and Lenders and a new Non-Bank Financial Intermediaries (NBFIs) bills which are expected to be passed in 2008. These reforms when implemented would represent a major transformation of the financial services sector. The Passage of the Banking Amendment Act, 2007 resulted in the issue of the first offshore banking licence to Barclays Bank this year.

30. Given the significant deadweight burden that the currency regime placed on the economy and recognizing the high transaction costs at the tellers, general inconvenience and high risks involved in carrying loads of currency for transaction purposes, the increasing difficulties in maintaining bookkeeping and statistical records, and the strain on the payments system, particularly the ATMs, the Bank of Ghana undertook a redenomination exercise this year

31. The reforms in the financial sector have been underpinned by a new fiscal/monetary policy framework with an emphasis on fiscal consolidation and monetary prudence within an inflation targeting framework. This has resulted in diminished inflation expectations, falling inflation and interest rates, exchange rate stability and sustained economic growth.

32. The economic transformation that has taken place has made it possible for the country to access the international capital markets with the issue of a \$750 million Eurobond.

33. The Ghanaian economy is therefore growing and becoming increasingly complex and high value financial transactions are likely to result in the near future. The economy is also getting increasingly integrated with the global economy. While these developments are opening up opportunities for banks, they also expose banks to more risks.

Minimum Paid up Capital of Bank and Non Bank Financial Institutions

34. Policy reforms have led to rationalization of major aspects of the financial sector thereby creating a new environment engendering efficiency and competition in the banking system, financial deepening, enhancing the transparency and competitiveness of the inter-bank money market and enhancing the development of the capital market.. The integration of the Ghanaian financial system with the global economy suggests that the new Foreign Exchange Act will provide opportunities for banks and non bank financial institutions. These new opportunities also bring in their wake higher risks which have to be cushioned by banks. However the existing capital base of banks constrains them in taking advantage of these new opportunities. Syndication has not proved to be successful in providing the needed capital cover for these new businesses, in part because each of the banks does not have adequate financial strength to support such syndication.

35. The reforms of the payment system including the introduction of the Real Time Gross settlement system and the switch to Codeline Clearing Truncation System also requires from financial institutions, standards associated with internationally active banks.

36. The establishment of the Central Securities Depository (CSD) which also facilitated the development of Primary Dealer System has brought many

challenges to primary dealers. A Primary Dealer System based on institutions with adequate financial resources is necessary to enhance liquidity and promote secondary market trading in securities.

37. The review of the Non-Bank Financial Intermediary Law will provide wider scope of activities for deposit taking non bank financial institutions and finance houses. These opportunities will expose them to higher risks which have to be covered by adequate capital.

38. With all these reforms, a cluster of banks has emerged with relatively low capital base and depth that are inadequate to support significant levels of lending; and could be more vulnerable to minor swings in macroeconomic fundamentals. However, a large number of banks with a small capital base within the system both dilute the franchise value of banks and increase instability. Entry therefore has to be selective, well-managed, and paced over time and clear exit rules and prudential supervision vigorously enforced to safeguard systemic stability.

39. An expansion of banking activities culminates in increase in exposures with their attendant risks. Financial institutions therefore need to reposition their capital to support these new activities in an expanding economy.

Proposed New Minimum Capital Requirements

40. The Bank of Ghana therefore proposes to increase the capital requirements of banks from GH¢7million to between GH¢50-60 million

41. The minimum capital requirements for deposit taking non bank financial institutions (NBFIs) and finance houses would increase and from GH¢1.0 million (and GH¢1.5 million) to between GH¢5-8 million .

Timetable for meeting the new Minimum Capital Requirements and Transitional Arrangements

- Banks and deposit taking non bank financial institutions are expected to submit capitalization plans by the end of June 2008. Submission of capitalization plans would guarantee continued access to the settlement and primary dealership systems.
- After December 2008, participation in the settlement system will be restricted to institutions that have met the capital requirements. (i.e. settlement banks with primary dealership status)
- To ensure an orderly consolidation, the banking system would allow for lower tier banks after December 2008. Banks that do not meet the capital requirements will belong to the lower tier.
- Banks and NBFIs granted licenses or provisional licenses within the last six months to date will be required to meet the new capital requirements within two years from the date of operations.
- New licenses for banks, deposit-taking NBFIs and Finance Houses would henceforth only be issued to banks that meet the new minimum capital requirements.
- The Bank of Ghana would continue with current policy of issuing bank licenses only to internationally active banks.