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SERIOUS LESSONS

Ensuring a sound banking sector, learning from the demise of UT Bank and Capital Bank

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Following the collapse of UT Bank (a bank formerly listed on the Ghana Stock Exchange) and Capital Bank, many questions regarding the soundness of Ghana's banking sector have been raised. A lot has been said about what really led to the demise of these two, both of which originally started as savings and loans companies, and the circumstances under which GCB Bank acquired the deposits and selected assets of the two entities.

The immediate past Managing Director of HFC Bank, Mr. Robert Le Hunte, was widely reported as saying that all of us were to blame for the situation of UT Bank and Capital Bank. Mr. Le Hunte posited, among other things, that customers as well as other institutional investors, who demanded high interest rates on fixed deposit investments, even in a low interest rate regime contributed to the demise of the aforementioned banks.

You cannot blame investors for demanding a higher rate of return on their investments. Neither can you blame banks who decide to offer relatively higher rates to attract more deposits. Investors would always push for higher interest rates on fixed income investments. Banks, especially new and smaller ones, may also decide to offer attractive rates that are usually above what is available on the market in order to attract more deposits. This is usually the easiest way to mobilize deposits but unfortunately it is also unsustainable in the long term. However, based on a widely acceptable benchmark interest rate and an appropriate premium for size and risk, there should be convergence of some sort with respect to the interest rates offered by universal banks across the board.

Broadly speaking, banks adopt different business models and strategies based on the category they fall in. Banks are categorized based on several matrices, which include country/region of origin, core business competence and asset quality, among others. An easy way to classify banks, with default risk in mind, is to consider the cost of funding associated with their operations.

Every Bank has its own operational strategy

The general business model of a typical bank is using depositor funds to earn revenue in a manner that is able to generate a reasonable return to shareholders. The value drivers for banks in Ghana vary across services to institutional clients; trading and treasury services; business and consumer lending; trade facilitation; and regional and integrated service delivery. All banks record revenue streams from funded and non-funded sources, with funded income providing the lion's share of revenue for most banks. Funded incomes are generated from the use of depositors' funds and other creditors of a bank. This arrangement requires that the receiving bank rewards depositors in the form of interest payment on the funds received. The receiving bank then deploys the funds into loans and investments in order to generate a higher return, over and above the interest paid to lenders of the bank, in order to record a profit. On the other hand, non-funded income are revenues banks receive from sources other than interest on loans given to customers. These include income from services rendered by banks such as underwriting, transaction advisory, research, trade facilitation, fund management, commissions, and charges on current accounts and on card services (ATM/VISA). The difference

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between what the bank pays on savings and time deposit accounts and what it receives from lending to customers is key to its profitability.

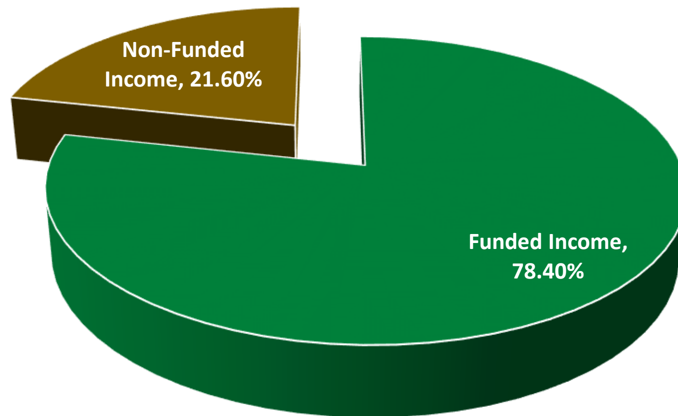

Figure 1: The contribution of Funded and Non-Funded Income to Revenue of Banks in Table 1 (2014-2016)

We define cost of funds as simply what banks pay on deposits and borrowings for onward lending and investments. We also determine the interest income received on funds, which indicates the return banks make when they lend out or invest mobilized deposits and borrowings. The difference between the costs of funds and the use of funds is the net interest spread. Table 1 gives a summary of banks based on the cost of funds.

Stable banks have low cost of funds

A cursory view of Table 1 shows that for the period 2014 to 2016, more stable banks were more likely to have lower cost of funds and higher net interest spread. Ghana Commercial Bank, Bank of Baroda, Ecobank Ghana, Standard Chartered Bank, Fidelity Bank, Societe Generale and Zenith Bank feature as banks with the highest spreads, above the industry average and low cost of funds, way below the industry average. With the exception of Societe Generale and Standard Chartered Bank, all these banks have NPL ratios that are below the industry average. Other banks aside from the seven such as CAL Bank and uniBank have low NPLs as well. The seven banks with the highest net interest spread collectively account for almost half (66.4%) of the total net assets out of the 18 banks included in the Table 1.

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	Rate Paid on Funds (%)	Interest Income on Funds (%)	Spread (%)	NPL Ratio (%)	CAR (%)
CAL	9.83	18.72	8.89	8	19.2
ACCESS	9.68	20.78	11.1	25.71	11.29
GCB	3.19	24.83	21.64	14	29
EGH	3.22	16.01	12.78	11.9	15.29
SOGEGH	3.48	14.54	11.06	16.9	16.73
ADB	13.99	18.45	4.45	43.94	14.08
HFC	10.52	23.40	12.87	17.4	11.5
Fidelity Bank	7.77	19.23	11.47	12.02	26.49
Zenith Bank	7.24	20.13	12.88	10.62	21.98
SCB	3.75	21.52	17.77	45	21.81
Royal	23.72	34.53	10.80	17	9.3
Baroda	2.65	14.61	11.95	0.04	85.17
GT Bank	6.21	15.62	9.41	12.88	22.06
SAHEL	12.36	21.09	8.73	0	13.99
uniBank	21.92	29.4	7.48	5.34	12.64
First Atlantic	7.61	16.73	9.12	N/A	26.3
Capital*	24.82	26.48	1.66	N/A	N/A
Omni*	32.24	35.46	3.22	N/A	N/A
Average	**11.34**	**21.75**	**10.40**	**16.05**	**22.30**

*Table 1 (Based on financial results from 2014-2016), * 2016 FY results not included*

Our observation is that banks that graduate from savings and loans into universal banks are likely to have high cost of funds. This is largely due to their operational set-up as many savings and loans companies have survived mainly by offering high rates to attract deposits while competing with other large banks. These deposits are then passed on in loan products to SMEs at relatively higher interest rates. Once there is an impairment of the loan book, which happens when loan clients default, the risk becomes magnified for banks that have high cost of funds as there is a wide asset-liability mismatch – a situation that leads to lower net assets or shareholders' equity.

The adverse effects of competition

In a bid to retain funds and attract more deposits, newer and smaller banks continue to offer above market interest rates for deposits. This leads to a dangerous cycle of having to pass on high interest rates to loan clients, which increases default risk – the risk of a borrower not being able to make interest payments to the lender and/or repay the principal amount borrowed when due. Beyond a certain threshold, any bank would find it practically impossible to continue to maintain high cost of funds due to issues with loan book quality.

Banks can be creative with their bottom line by reporting other earnings but this does not mean that all is well with the bank. A closer look at the sources and cost of funds, sectoral distribution of the loan book, impairment charges, capital adequacy ratio and liquidity ratios would reveal the true picture. However, these are technical and as such the ordinary customer would not be in a position to properly assess the potential risk of default by deposit taking institutions as they may not have or pay attention to all the facts surrounding the financial health of these institutions. What most depositors are interested in is "What rate are you offering me? "and "How much would I get after 3 months?", without recourse to default risk on the part of the bank.

Institutional investors, however, must know better. Pension Fund Managers (PFMs) and insurance companies who conduct credit analysis on issuers know the banks that have high cost of funds, simply by observing the interest rates they promise to pay on deposits. The resultant effect is that these banks must deploy the funds into higher yielding investments in order to make a decent spread. This increases the likelihood of giving out bad loans or making risky investments thereby leading to possible loss of depositor funds. It is one of the reasons for the divergence of the bank base rate for lending and the BOG's policy rate. Indeed, lending rates in Ghana are still high despite the easing monetary conditions we have witnessed in 2017. But again, the risk of PFMs

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reporting lower returns compared to their competition forces them to remain exposed to some of these risky banks. Pension fund trustees, who require quarterly reports on the performance of their schemes, indirectly pressurize PFMs to earn above market returns. As a result, PFMs may overlook key information and continue to make placements with some risky banks provided the interest rates are relatively attractive.

What can be done?

The BOG has a responsibility to ensure that the banking sector is strong and poised to play its role in national development. The Bank of Ghana publishes Annual Percentage Rates (APR) and Average Interest (AI) paid on deposits on a quarterly basis, indicating what the average industry rates are. This is a good starting point. However, just as there is a mandatory capital adequacy ratio and base rate, which provides guidance with respect to lending rates, there is the need for guidance when it comes to interest rates paid on deposits, using data from all banks and making reasonable adjustments where necessary. This can be updated periodically as market dynamics change. Some banks may need saving from the current practice of having to keep up with offering higher interest rates but they simply cannot self-correct themselves, or they may do so when it has become too late. This is where the role of regulation comes to play.

The BOG can go further by probing why some banks consistently have cost of funds above the industry average based on prevailing market conditions. The banks must agree to and strive to fall within the acceptable cost of funding limit the same way they strive to meet the capital adequacy ratio. This should not affect the strategy of banks as the banks themselves would be the biggest beneficiaries. For large and established banks, who do not offer exorbitant rates, a move to ensure convergence on the market would only consolidate their strategy on deposit mobilization. For smaller and newer banks, the convergence would mean than the pressure associated with offering higher interest rates just to stay competitive would be eliminated. This would translate into cheaper cost of funding which would reduce cost of operations and redirect focus to innovation, technology and other value added services. For the consumer, there is reduced default risk. Of course, there would be a margin that would incorporate the unique characteristics of each bank in determining interest rates offered on deposits. With time, this unique characteristics would be reflected in the rates themselves. For instance, smaller and newer banks with inherently higher risk, may have to offer reasonably higher interest rates than others. This mechanism would also safeguard depositors from being offered interest rates that are way below reasonable market levels. The investing public is then guided as to what to expect when placing funds with deposit taking institutions. PFMs and insurers would be compelled to place with banks that have acceptable rates. This is because there would be no outlier banks offering outrageous interest rates.

In addition, it is high time local private rating entities emerged to, among other things, provide ranking of banks along key metrics, one of which should be the cost of funds for banks. The Ghanaian capital market has grown to the point where such services are required. It is worthy to note that the Finance Minister alluded to this in the 2018 Budget and Economic Policy Statement. This would help deepen the Ghanaian capital market and from a risk point of view, ensure that financial institutions put their houses in order. Rating agencies would show which banks are risky and issue an opinion which ostensibly precludes PFMs and insurers from dealing with those banks below a certain rating level. This arrangement would force PFMs and insurers to avoid high cost of funds.

Finally, for listed banks, the BOG and the Ghana Stock Exchange (GSE) could ensure that banks publish their financial statements as required by law and enforce increased and timely disclosures of material information that would have an impact on the share price of these banks. Delays and non-publication of results should come with punishment and regulatory sanctions in order to ensure compliance.

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This is not an affront to free markets

The premise for any intervention is that there is the need to safeguard the integrity of the banking system. Sometimes, sitting unperturbed and waiting for the market to self-correct has dire consequences, as it is mostly the case with market failures. Considering the fact that many shareholders lost their investments in UTB, it behoves on all of us to ensure that there is trust and confidence in the financial services sector. Regulatory pro-activeness towards ensuring stability in the financial system cannot be an affront to free markets. Rather it would provide the impetus for banks to offer market driven interest rates and not take the shortcuts to deposit mobilisation by offering above market interest rates. In the long-run, the potential roll-over risk would be factored in interest rates offered by all the banks so that banks would not have to be driven by loss of depositor funds once the tenor of deposits expire. The interventions outlined here would ensure that bankers develop innovative means of attracting deposits and improving service delivery.

Conclusion

The call for convergence does not mean that banks cannot compete on rates offered for deposits. It simply means that banks can compete on other fronts to enhance value. Market conditions may move the convergence range upwards or downwards in such a manner that there is room for banks to mobilize more by offering marginally higher rates based on the strength of their balance sheet and not just in response to competition. The competitive nature of the banking sector can drive attention to other value generating activities. Banks that offer high interest rates can do so if they believe it provides adequate compensation for the risks depositors are exposed to. Interest rates offered on deposits should be based on risk and must not be a shortcut to simply accumulate more funds.

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