

Strategic Document for Improvements in Financial Sector Regulations and Supervision

May2000



Sigma One Corporation

Strategic Document for Improvements in Financial Sector Regulations and Supervision

**A Report of the Financial Intermediation Sub-Committee of the
Financial Sector Consultative Committee**

Submitted to:

**U.S. Agency for International Development
Mission to Ghana**

for:

**Trade and Investment Reform Program (TIRP)
Improved Policy Reform and Financial Intermediation
USAID Contract Number: 641-C-00-98-00229**

by:

Sigma One Corporation

In fulfillment of the following milestones:

- 3.13 Prepare Strategic documents for improvements in the financial sector regulations and supervision**

May 2000

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EXECUTIVE SUMMARY

The Financial Sector Consultative Committee (FSCC) was set up by the Bank of Ghana as part of a larger programme on Trade and Investment Reform overseen by the Inter-Ministerial Committee on Competitiveness (IMCC). At its first meeting, the FSCC established the following Sub-Committees:

- 1) The Legal, Regulatory and Supervisory Sub-Committee (LRSSC)
- 2) The Financial Intermediation Sub-Committee (FISC)

The mandate of FISC was to review the state of financial intermediation in Ghana, identify the constraints on financial intermediation and make recommendations for improving financial intermediation. The recommendations were to be forwarded to the FSCC for onward transmission to IMCC for consideration, adoption and implementation.

A list of members of FSCC and its sub-committees are attached as Annex A. The work plan of FISC is attached as Annex B. The work plan had the following components:

- 1) Identification of constituents and stakeholders of the financial system.
- 2) Submission of situational reports on the overview and status of various sub-sectors within the financial sector.
- 3) Review and evaluation of the reports with a view to harmonizing and consolidating the identified issues and constraints in the financial sector and preparation of recommendations for reform.

General Issues

The Sub-Committee's deliberations identified issues of a general nature that constrain financial intermediation in Ghana. Specifically, the following issues were identified.

- 1) High inflation and interest rate environment
- 2) Market volatility and uncertainty
- 3) Determination of interest rates by the Bank of Ghana
- 4) Lack of a long-term debt market
- 5) Limited secondary market for government debt
- 6) Absence of a fund management industry
- 7) Lack of a credit information system.

Recommendations

- The Bank of Ghana needs to increase its investment in public information and education in order to dispel the widespread perception of interference in the weekly Treasury Bill auction. This should include periodic general forums to educate the public.

- The rules governing the conduct of the weekly Treasury Bill auction should be published for the information of the public
- To promote the development of a fund management industry:
 - There should be a partial outsourcing of the management of SSNIT funds.
 - Government should promote private pension funds
 - The Securities Regulatory Commission should accelerate development of collective investment schemes.
 - The National Insurance Commission should liberalize rules for insurance company investments within prudential guidelines.
- The development of a credit information system should be accelerated through the following measures:
 - Efforts to establish a credit reference agency, credit bureau and rating agency should be intensified.
 - The Bank of Ghana, the Securities Regulatory Commission and the National Insurance Commission should mandate the use of the Social Security Number for all financial sector transactions (banking, brokerage and insurance) as part of prudential requirements.
 - Business users of financial services should be identified by the taxpayer Identification Number (TIN).

Sector Issues

Banking Sector

The banking sector has the following characteristics:

- 1) Excessive market concentration.
- 2) A low level of savings.
- 3) A high level of currency outside the banking system.
- 4) A payments system that is inadequate to support the settlement of financial transactions.
- 5) Excessive foreign exchange risk exposure.
- 6) High cost of financial intermediation reflected in high spread between borrowing and lending rates.

Recommendations

- The Bank of Ghana should foster greater competition by requiring banks to publish and display banking charges, interest rates and commissions and to give adequate notice when changes are being made to the schedule of fees.

- The Association of Banks should sponsor broader public education about activities of banks.
- Steps should be taken to improve the effectiveness of cheques as a payment mechanism.
- Efforts of the National Payments Council to bring rural banks, credit unions and savings and loan companies into the payments system should be intensified.
- Government should set an example by ensuring that government cheques are not returned unpaid for whatever reason.
- The banking industry should explore possibilities outside the legal system for sanctioning habitual writers of dud cheques (including higher charges, sponsoring private sector cheque verification companies, etc.)
- Net foreign exchange risk exposure should be set depending on bank strength.
- Regulation of banks should be brought up to international standards.
- Efforts to link microfinance institutions to the formal banking system should be intensified.

Securities Industry

The securities industry faces the following constraints:

- 1) No long term debt instruments. There is no credit rating agency to support development of a debt market.
- 2) Inequitable tax treatment of dividends and interest income. Dividends are taxed at 10%, while interest income is tax-free.
- 3) Inadequate knowledge of securities industry by public officials.
- 4) Small number of listed companies reflected in an insufficient number of capital market instruments.
- 5) High flotation costs are a disincentive for small companies to list.

Recommendations

- Build capacity of public officials through public education campaign.
- Create a level playing field by exempting dividend income from tax.
- The market needs a medium-term government debt instrument to provide a benchmark interest rate and extend the yield curve. The Bank of Ghana should provide a benchmark 3- 5-year bond, to be issued at least once a year.
- Tax incentives should be created for companies wishing to list on Ghana Stock Exchange by providing a generous one-time allowance for flotation costs.

SSNIT

- 1) SSNIT may not have the in-house capacity to effectively manage the large pool of pension funds. Because of this, returns are low.

- 2) Monopoly of the management of the national pool of pension contributions has inhibited the growth of a fund management industry and the optimal use of pension funds for private sector investment.

Recommendations

- Outsource funds to professional fund managers. This would support the development of a fund management industry and improve the efficiency of capital allocation.
- Outsource corporate lending to financial institutions by providing wholesale funds.

INSURANCE

- 1) High inflation rate in the economy erodes capital base of insurance companies thereby reducing their retention capacities, creates massive underinsurance of assets and makes life insurance unattractive.
- 2) The insurance industry lacks training facilities.
- 3) Foreign credit lines to the government always incorporate insurance with foreign firms.
- 4) Public awareness of the benefits of insurance is low.
- 5) Reinsurance companies outside Ghana transact business in Ghana.

Recommendations

- The National Insurance Commission and the Insurers Association should collectively step up educational programs in print and electronic media to educate the public on the benefits of insurance.
- The National Insurance Commission should work with the insurance industry to set up a training facility.
- Government should use Ghanaian insurers to insure foreign credit lines to the government.
- A national reinsurance policy should be put in place to ensure maximum retention by Ghanaian companies.

MICROFINANCE

- 1) Weak financial performance.
- 2) Management productivity as measured by loans-to-assets ratio is low.
- 3) Credit and delinquency management is a problem.
- 4) Weak governance and management.
- 5) Low outreach and penetration.
- 6) Ineffective supervision and regulation.

Recommendations

- Rural Banks
 - Develop stringent rating system to identify strong rural banks.
 - Strong rural banks should be integrated into the national banking system through interlinkages.
 - Stricter enforcement of corrective measures and penalties for non-compliance with sound banking practices.

- Credit Unions/Savings and Loans
 - Reserve requirements should be aligned with those of banks, with supplementary requirements if necessary.
 - Promote capacity-building programs for CUA and Savings and Loan companies.

- Susu Collectors
 - All susu collectors should be registered.
 - Strengthen national and regional associations to be self-regulated.
 - Link largest susus with formal financial institutions.

REPORT OF THE FINANCIAL INTERMEDIATION SUB – COMMITTEE

Background

The Financial Sector Consultative Committee was set up by the Bank of Ghana as part of a larger programme on Trade and Investment Reform overseen by the Inter-Ministerial Committee on Competitiveness (IMCC). At its first meeting the FSCC established two sub-committees:

- 1) The Legal, Regulatory and Supervisory Sub-Committee (LRSCC)
- 2) The Financial Intermediation Sub-Committee (FISC)

The mandate of FSCC was to review the state of financial intermediation in Ghana, identify the constraints on financial intermediation and make recommendations for improving financial intermediation. The recommendations were to be forwarded to the FSCC for onward transmission to IMCC for consideration, adoption and implementation.

List of members of FSCC and its sub-committees are attached as Annex A. The work plan of FISC is attached as Annex B. The work plan had the following components:

- 1) Identification of constituents and stakeholders of the financial system.
- 2) Submission of situational reports on the overview and status of various sub-sectors within the financial sector.
- 3) Review and evaluation of the reports with a view to harmonizing and consolidating the identified issues and constraints in the financial sector and preparation of recommendations for reform.

GENERAL

The Sub-Committee's deliberations identified issues of a general nature that militate against financial intermediation in Ghana. Specifically, the following issues were identified.

- High inflation and interest rate environment
- Market volatility and uncertainty
- Absence of a Credit Rating Agency
- Determination of interest rates by the Bank of Ghana
- Lack of a long-term debt market
- Limited secondary market for government debt
- Lack of universal identification for the tracking of financial sector transactions.

MARKET ENVIRONMENT

High inflation works against long-term investment since investors are worried about maintaining the real purchasing power of capital. The market is also characterized by a high degree of volatility. The following data are instructive:

		1995	1996	1997	1998	1999
1	Interbank Exchange Rate (Year End (¢/US \$))	1445	1740	2250	2346	3440
2	% Cedi depreciation	-25.6	17.0	-22.7	-4.1	-31.8
3	Year-on-Year Rate of Inflation (%)	57.5	-46.6	27.9	19.3	13.8
4	GSE All-Share Index (%) Change	6.33	13.8	41.9	69.7	-15.2

The volatility of the financial market indicators adds to the perceived risk of engaging in financial transactions.

Interest Rates and Government Debt Market

There is a widespread perception that the treasury bill auction conducted by the Bank of Ghana is not a clean auction. It is widely believed that the Bank of Ghana always has a reservation price and does not accept bids that fall below the reservation price. Although there is no direct evidence of manipulation of the auction to achieve a pre-determined rate, many members expressed surprise that the interest rate could be that stable if the auction was a clean auction.

In his presentation, the Head of Treasury of the Bank of Ghana denied that the Bank of Ghana was fixing the Treasury Bill rates. Rather, the Bank has been surprised that the bidders consistently stuck to the same bids week after week, even in the face of changing liquidity conditions in the market.

The Committee concluded that the perception of a predetermined auction might be the lack of understanding of the auction procedure.

RECOMMENDATION

- 1) The Bank of Ghana needs to increase its investment in public information and education in order to dispel the widespread perception of interference in the weekly Treasury Bill auction. This should include periodic general forums to educate the public.
- 2) The rules governing the conduct of the weekly Treasury Bill auction should be published for the information of the public.

CREDIT INFORMATION SYSTEM

A necessary condition for an efficient financial system is that there should be readily accessible information about participants in the system. The absence of such information creates moral hazard and adverse selection costs that can cause credit markets to fail. Market failure is reflected in the unwillingness of lenders to extend credit at any price. Creditworthy borrowers are shut out of the market.

Moral hazard arises from the inability of a lender to observe the actions of a borrower after credit has been extended. Adverse selection occurs because borrowers have more information about themselves than the lender and are unwilling to reveal

negative information about themselves. Lenders who are uncomfortable about how much they know about the borrower, therefore, will not extend credit.

In economies with advanced credit markets, significant investment has been made in building an infrastructure for collecting, storing and retrieving information about participants in the financial system, as reflected in the widespread existence of credit bureaus that maintain information. A starting point for a credit information system is the availability of systems for identifying participants in the market. The absence of such an identification system in Ghana has been a major factor in the low level of credit market development.

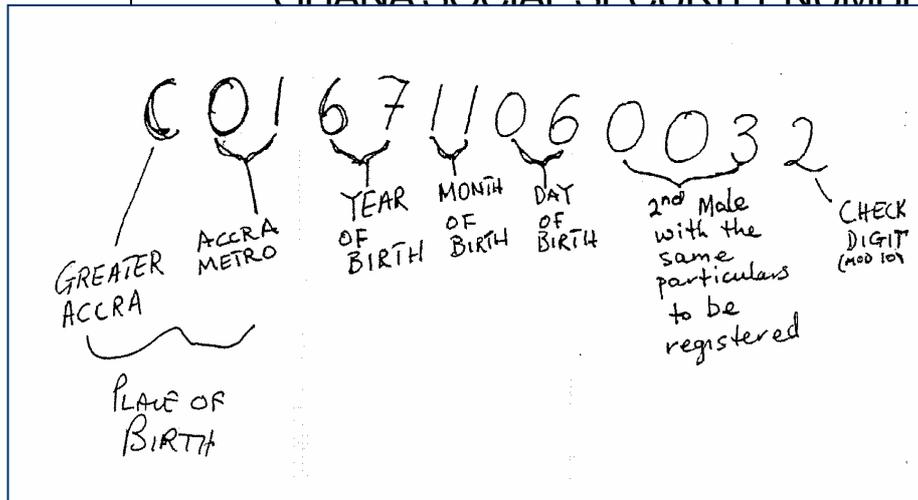
The Sub-Committee believes that the basic building blocks for an identification system already exist in the current Social Security Number, which underpins the SSNIT pension scheme. A universal adoption of the Social Security Number would provide the basis for a credit information system. Additionally, databases of important registries, such as the land registries, could be based on the Social Security Number to facilitate collection, storage and retrieval.

The Committee recognizes that widespread information about individuals could fan fears about loss of privacy. The adoption of Social Security Numbers should be accompanied by guidelines on how information may be transferred amongst financial institutions and between financial institutions and other organizations.

RECOMMENDATIONS

- 1) The Bank of Ghana, the Securities Regulatory Commission and the National Insurance Commission should mandate the use of the Social Security Number for all financial sector transactions (banking, brokerage and insurance) as part of prudential requirements.
- 2) Business users of financial services should be identified by the taxpayer Identification Number (TIN)
- 3) The adoption of Social Security Numbers should be coordinated with SSNIT to ensure that identification numbers would be issued to all who need one.
- 4) Public education should be put in place to allay fears about loss of privacy.

GHANA SOCIAL SECURITY NUMBER



Features of 13-Digit SSN

- Region of Birth
- District of Birth
- Year/Month/Day of Birth
- Unique number for the individual
- Check digit

Credit Reference Agency

One of the main components of the Private Enterprise and Export Development (PEED) Project funded by IDA is the establishment of a Credit Reference Agency (CRA) in Ghana.

In this connection, a consortium composed of Sterling International Group Inc. and Dun & Bradstreet Information Services, was commissioned to study the feasibility of establishing a CRA in Ghana. The feasibility study established the need for, and the potential viability of a CRA.

CREDIT REFERENCE SERVICES

The CRA, when established, will offer a full range of credit reference and rating services to Ghanaian and foreign entities interested in obtaining general and creditworthiness information on Ghanaian companies. This will be done through the

issue of business information and background on the existence of the business and its financial statements.

OWNERSHIP OF THE CRA

The proposed CRA will operate as private sector agency. The ownership will include key users and suppliers of information to the CRA, such as banks and non-bank financial institutions.

ACTION TOWARD ESTABLISHMENT

Upon acceptance of the recommendation for the establishment of CRA, the Bank of Ghana commissioned Sterling International Group to develop a Business Plan for the CRA. The Business Plan has been submitted and the Bank of Ghana is taking steps to get equity shareholders for the CRA. It is expected that with the facilitating role of the Bank the CRA will come into operation soon.

RECOMMENDATION

- 1) Bank of Ghana should accelerate the establishment of the Credit Reference Agency by outsourcing the equity placement to a private sector investment/merchant banking outfit.
- 2) The proposed CRA should work with the Association of Banks to collaborate with the borrowers database, which is being developed by the Association.

FUND MANAGEMENT INDUSTRY

The benefit of having a fund management industry is the intensification of competition in the financial system. The development of new sources of finance from non-bank financial intermediaries, such as pension funds and mutual funds, forces dominant banks to become more competitive and to start searching out their customers, rather than waiting for prospective borrowers to visit them.

The development of a fund management industry also fosters competitive bidding for issues of securities. The greater availability of financial resources encourages companies to place new issues directly with fund managers. Fund managers also support the growth of venture capital funds and the provision of private equity, both of which help finance new and expanding smaller firms.

RECOMMENDATIONS

- 1) There should be a partial outsourcing of the management of SSNIT funds.
- 2) Government should promote private pension funds
- 3) SRC should accelerate development of collective investment schemes.
- 4) NIC should liberalize rules for insurance company investments within prudential guidelines.

THE BANKING SECTOR

The banking sector is characterized by

- 1) Excessive market concentration.

- 2) A low level of savings.
- 3) A high level of currency outside the banking system.
- 4) A payments system that is inadequate to support the settlement of financial transaction.
- 5) Excessive foreign exchange risk exposure.
- 6) High cost of financial intermediation reflected in high spread between borrowing and lending rates.
- 7) A supervision system that is not up to international standards.

RECOMMENDATIONS

- 1) The Bank of Ghana should foster greater competition by requiring banks to publish and display banking charges, interest rates and commissions and to give adequate notice when changes are being made to the schedule of fees.
- 2) The Association of Banks should sponsor broader public education about activities of banks.
- 3) Steps should be taken to improve the effectiveness of cheques as a payment mechanism.
 - Efforts of the National Payments Council to bring rural banks, credit unions and savings and loan companies into the payments system should be intensified.
 - Government should set an example by ensuring that government cheques are not returned unpaid for whatever reason.
 - The banking industry should explore possibilities outside the legal system for sanctioning habitual writers of dud cheques (including higher charges, sponsoring private sector cheque verification companies, etc.)
- 4) Net foreign exchange risk exposure should be set depending on bank strength.
- 5) Regulation of banks should be brought up to international standards.
- 6) Efforts to link microfinance institutions to the formal banking system should be intensified.

SECURITIES INDUSTRY

The securities industry faces the following constraints:

- 1) No credit rating agency to support development of a debt market.
- 2) No long term debt instruments.
- 3) Inequitable tax treatment of dividends and interest income. Dividends are taxed at 10%, while interest income is tax-free.
- 4) Inadequate knowledge of securities industry by public officials.

- 5) Small number of listed companies reflected in an insufficient number of capital market instruments.
- 6) High flotation costs are a disincentive for small companies to list.

RECOMMENDATIONS

- 1) Build capacity of public officials through public education campaign.
- 2) Create a level playing field by exempting dividend income from tax.
- 3) The market needs a medium-term government debt instrument to provide a benchmark interest rate and extend the yield curve. The bond should be properly structured to correct the liquidity weakness of the GSE Commemorative Stock which failed.
- 4) Bank of Ghana should undertake a study on the feasibility of issuing inflation-indexed boards.
- 5) Tax incentives should be created for companies wishing to list on Ghana Stock Exchange.

SSNIT

SSNIT is a major player in the financial market because it controls one of the largest pool of savings in Ghana. The management of the pool of savings will have a significant impact on the allocation of capital within the economy. The Sub-Committee was of the view that SSNIT may not have the in-house capacity to effectively manage the large pool of pension funds and that it should take advantage of investment management capacity in the private sector by partially outsourcing its investment management.

RECOMMENDATIONS

- 1) Outsource funds to professional fund managers. This would support the development of a fund management industry and improve the efficiency of capital allocation.
- 2) Outsource corporate lending to financial institutions by providing wholesale funds.

INSURANCE

The following issues were identified for the insurance industry

- 1) High inflation rate in the economy:
 - Erodes capital base of insurance companies thereby reducing their retention capacities,
 - Creates massive underinsurance of assets
 - Makes life insurance unattractive
- 2) The insurance industry lacks training facilities

- 3) Foreign credit lines to the government always incorporate insurance with foreign firms.
- 4) Public awareness of the benefits of insurance is low.
- 5) Reinsurance companies outside Ghana transact business in Ghana

RECOMMENDATIONS

- 1) Macroeconomic stability should be pursued vigorously as this is a necessary condition for the survival and growth of the insurance industry.
- 2) The National Insurance Commission and the Insurers Association should collectively step up educational programs in print and electronic media to educate the public on the benefits of insurance.
- 3) The National Insurance Commission should work with the insurance industry to set up a training facility.
- 4) Government should use Ghanaian insurers to insure foreign credit lines to the government.
- 5) A national reinsurance policy should be put in place to ensure maximum retention by Ghanaian companies.

MICROFINANCE

Microfinance is the provision of financial services (credit and savings) to a large number of micro, small and medium scale entrepreneurs, the productive, but resource poor, including women, in a cost-effective manner. The ability to access small cushions of savings and even buy or invest in small amounts of insurance can make a radical difference in the lives of individuals formerly lacking access to such services. The microfinance industry consists of Micro-Finance Institutions (MFIs) as providers of financial services. The government, including the Bank of Ghana, plays a major role in the sector as policy designer, regulator and supervisor. Donors are also active in this sector as providers of development funds and technical assistance.

Microfinance institutions can be formal, semi-formal and informal. Formal MFIs include 133 Rural Banks, 200 Credit Unions, 8 Savings and Loan companies and some commercial and development banks (notably, the Agricultural Development Bank, Ghana Commercial Bank and Social Security Bank Limited). Servicing small-scale cocoa and food-crop farmers, as well as fishermen, is a thrust of the Agricultural Development Bank. The semi-formal MFIs are the numerous "Susu" and Susu clubs which are prevalent in and around market places. This informal system operates on the basis of daily deposits by customers, with a monthly return of cash, less a day's deposit for the services of the *susu* collector. The key informal MFIs are Rotating Savings and Credit Associations (ROSCAs) and moneylenders, on whom information is very scanty.

ISSUES

Formal Microfinance institutions (Rural Banks, Savings & Loan, Credit Unions)

- 1) Weak financial performance. Management productivity as measured by loans-to-assets ratio is low. Credit and delinquency management is a problem.

- 2) Weak governance and management.
- 3) Low outreach and penetration.
- 4) Ineffective supervision and regulation

Semi formal/Informal institutions

- 1) Low public trust due to non-regulation.
- 2) Little or no interest on deposits.
- 3) Little or no wholesaling by banks to *susus*.
- 4) High *susu* fees/commissions.

RECOMMENDATIONS

1) Rural Banks

- Develop stringent rating system to identify strong rural banks.
- Strong rural banks should be integrated into the national banking system through interlinkages.
- Stricter enforcement of corrective measures and penalties for non-compliance with sound banking practices.

2) Credit Unions/Savings and Loans

- Reserve requirements should be aligned with those of banks, with supplementary requirements if necessary.
- Promote capacity-building programs for CUA and Savings and Loan companies.

3) *Susu* Collectors

- All *susu* collectors should be registered.
- Strengthen national and regional associations to be self-regulated.
- Link largest *susus* with formal financial institutions.

Financial Sector Consultative Committee

1. Teresa Ntim, Bank of Ghana (Chairperson)
2. Kwame Aboagye, SEM Financial Group Limited
3. William Adote, Ministry of Finance
4. Yeboa Amoa, Ghana Stock Exchange
5. Felix Y. Biga, SSNIT
6. Jesse Clotley, Private Enterprise Foundation
7. Nyamikeh Kyiamah, National Insurance Commission
8. D.K. Mensah, Ghana Association of Bankers
9. Fred Nuer, Association of Stockbrokers
10. Mark Owusuansah, Ministry of Finance
11. Eudora Quartey, Securities Regulatory Commission
12. Jay Salkin, Sigma One Corporation
13. Nii Kwaku Sowa, Centre for Policy Analysis
14. Wilson Tei, Ghana Insurers Association
15. Adu A. Antwi, Securities Regulatory Commission

Legal, Regulatory and Supervisory Sub-Committee

1. Jacob Arko Saah, Registrar-General's Department (Chairperson)
2. Mahmoud Hantour, Ghana Association of Bankers
3. Eudora Quartey, Securities Regulatory Commission
4. Joe Aboagye Debrah, Ghana Stock Exchange
5. Jay Salkin, Sigma One Corporation
6. Wilson Tei, Ghana Insurers Association
7. Charles Obeng Inkoom, Chartered Institute of Bankers
8. Jojo Acquah, Deloitte & Touche
9. Paul Asimenu, Ministry of Finance
10. Emma Ocran, National Insurance Commission
11. Adu A. Antwi, Securities Regulatory Commission
12. Daniel O.K. Owusu, Bank of Ghana
13. Kofi Amoa-Awuah, Bank of Ghana
14. Fred Nuer, Association of Stockbrokers
15. Tony Osei, Centre for Policy Analysis

Financial Intermediation Sub-Committee

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5. Fred Nuer, Association of Stockbrokers
6. Mark Owusuansah, Ministry of Finance
7. Jay Salkin, Sigma One Corporation
8. Nii Kwaku Sowa, Centre for Policy Analysis
9. I. Owusu Hemeng, Chartered Institute of Bankers
10. Joseph K. Forson, Deloitte & Touche
11. Ekow Afedzie, Ghana Stock Exchange
12. Abraham K. Boateng, National Insurance Commission
13. Grace Akrofi, Bank of Ghana
14. Adu A. Antwi, Securities Regulatory Commission
15. Alexis F.K. Anning, AFTECH Limited.

Secretariat

Sam Mensah, SEM International Associates, Financial Economist/Consultant
Sharon Dankwa, Bank of Ghana
Johnson P. Asiana, Bank of Ghana

ANNEX B: WORK PLAN OF THE FINANCIAL INTERMEDIARY SUB-COMMITTEE

DATE	ACTION
January 26, 2000	Identification of constituents and stakeholders of financial system.
February 8, 2000	Submission of situational reports on overview and status of the various sub-sectors within the financial sector.
February 17, 2000 – March 2, 2000	Review and evaluation of the reports with a view to harmonizing and consolidating the identified issues and constraints in the financial sector and preparation of recommendations for reforms.
March 9, 2000	First draft report of the overview of the various sectors within the financial sector prepared.
March 16, 2000	Final draft report, including identification of needed reforms and proposed strategic plan for financial sector development.
After March 16, 2000	Consultation with stakeholders (Financial Sector Conference in April) and preparation of the final draft Strategic Plan.