

CHALLENGES AND OPPORTUNITIES FACING THE FINANCIAL SERVICES INDUSTRY IN A STABLE MACROECONOMIC ENVIRONMENT

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Mr. Chairman, Honourable Senior Minister, distinguished ladies and gentlemen, I feel honoured indeed to have been invited to give the keynote address at this high level gathering of financial professionals in Ghana. The Institute has given us a theme which will clearly challenge our thinking. The theme brings into focus the relationship between macro economic stability and the delivery of financial services. We will shortly address the issue of whether we are in a stable or unstable macroeconomic environment. However, before we do that, I would like to map out how the macroeconomic environment and financial institutions interact within an economy. That will set the stage for considering where we stand in Ghana and what opportunities and challenges our situation presents.

The role of the financial institutions is to mobilize savings and allocate them to those in need of funds. They do this by providing brokerage and asset transformation services. As brokers, financial institutions act as agents for savers and issuers of debt and equity instruments by providing information and transaction services. As asset transformers, financial institutions offer liquidity, maturity and size intermediation. The existence of financial institutions clearly encourages a higher level of savings and investment and ultimately a higher rate of economic growth. Many financial institutions provide specialized services to the economy. Banks, for example, provide payment services and provide a transmission mechanism for monetary policy; pension funds and insurance companies enable us to spread our incomes over our lifetimes; mutual funds and unit trusts provide a mechanism for pooling small savings into large pools of capital while securities firms have specialized in providing risk management instruments. Failure to provide these services can be costly to the economy since efficient financial services are a necessary condition for sustainable economic growth.

A stable macroeconomic environment promotes the savings necessary to finance investments - a precondition for achieving sustainable economic growth. Participants in the financial system are sensitive to economic fundamentals. What I mean to say is that investors factor macroeconomic variables into their investment decisions. These macroeconomic variables

include among others the size of the current account deficit in relation to foreign exchange reserves, government debt, government deficits, inflation, interest rates and exchange rates.

Ghana's macroeconomic policies over the last decade have been characterized by periodic financial discipline slippages, leading to volatile and generally high inflation, large exchange rate swings, and negative real interest rates for extended periods. The most recent example of macroeconomic imbalances includes the severe terms of trade shock of 1999-2000, combined with fiscal slippages, which resulted in double digit inflation rates in 2001 and 2002, 15 percent exchange rate depreciation, and the build-up of a sizable domestic government debt. The high degree of uncertainty associated with Ghana's unstable macroeconomic environment has negatively affected both the size and the quality of financial intermediation and has been reflected in the behaviour of participants in the financial system in the following ways:

- Savers are unwilling to invest in long-term instruments because of the fear of inflation built up over several years of unstable and high inflation. Long-term savings is virtually nonexistent as one-third of all bank deposits are demand deposits.
- The lack of long-term savings constrains the availability of long-term capital. Banks are unwilling to make term loans at fixed interest rates because of the fear of interest rate volatility, or more specifically, unexpected interest rate increases that increase the cost of funds that are used to fund loans and advances. Interest rate risk is therefore shifted almost wholly to hapless borrowers who have no avenues for hedging interest rate risk.
- The cost of capital is higher than it will otherwise be because lenders and equity investors demand a high risk premium to compensate them for the risk of providing funds to businesses
- Business investment is constrained by uncertainty about the cost of capital, Therefore businesses also focus on the short-term, i.e. by concentrating on business activities that have a short cash conversion cycle. In popular parlance, we say that Ghanaians are all traders.

Because of our inability to sustain macroeconomic stability, the financial sector reforms that we embarked on in the 1980s did not achieve the intended goal of enhancing private savings. Inflationary pressures during the reform period resulted in negative real rates of interest. As a result the savings response was weak. Ghana's savings and investment performance are low even by sub-Saharan African standards. Our Gross Domestic Savings to GDP in 2003 was 5.6% compared to 26.9% for Botswana and 22.7% for Nigeria. Gross Domestic Investment to GDP in 2003 was 19.4% for Ghana, 44.1% for Botswana and 22.7% for Nigeria. Private sector credit to GDP stood at 11.8% in 2002 compared to a sub-Saharan average of 15.2%

Before we address the challenges and opportunities, I would like us to reflect a little further on where we stand today on macroeconomic stability. It is quite obvious that the key macroeconomic indicators have shown favourable trends in recent years.

- The budget balance has trended down to -3.4% of GDP from 8.5 in 2000
- The annual depreciation of the cedi against the U.S. dollar has fallen from 33% in 1999 to 4.7% in 2003
- The 91-Day Treasury Bill rate is now at 17% from 42% in 2000
- The annual inflation rate is still volatile although it was down to 11.8% in December 2004 compared to 33.45% in 1999.

Do these statistics represent macroeconomic stability? My humble answer is "Not Yet". The reason is that financial decision making is based on expectations, and most economists believe that expectations are rational. People learn very quickly and, by learning the patterns of economic activity, can often anticipate, experience and adapt to changes in economic circumstances as they happen -- rather than after. Thus, the basic assumption of rational expectations is that people make efficient use of all the information available to them. In effect, everybody acts as an economic forecaster, gathering information to judge what kinds of economic events are likely. As an example, the value of a currency and its rate of depreciation depend partly on what people expect that rate of depreciation to be. That is because people rush to desert a currency that they expect to lose value, thereby contributing to its loss in value.

The theory of rational expectations provides some overriding principles that apply to countries promoting a stable macroeconomic environment. First, economic discipline is the cornerstone of success. It helps shape the market perception and investors' confidence in the policies pursued by a country. Second, policies should be consistently implemented to assure economic agents that the favourable business climate will last. Third, credibility is very important: once lost, it takes great efforts and time to regain.

Thus, despite our justifiable impatience to declare victory over macroeconomic instability, users of financial services are still hanging on to expectations of instability that have been embedded over several years. We should not, for example, expect the public to start investing in long-term instruments just because the statistics show two years of reduced macroeconomic volatility. Expectations take time to change and we cannot expect any immediate adjustment in expectations. As we speak, rational participants in the financial system are already anticipating increases in the inflation rate and interest rates for 2005 because of widely expected increases in petroleum prices. Some forecasters are already predicting an inflation rate of 18% for 2005. That would mean that over the period 2001-2005 the inflation rate will have decreased in 2002, increased in 2003, decreased in 2004 and increased in 2005. Clearly, if expectations are rational, then in the face of such volatility, macroeconomic stability cannot exist at the level of expectations, which is what matters for financial decision-making.

Opportunities and Challenges

The endurance of expectations of macroeconomic instability means that current savings and investment habits will persist for a while. When expectations of macroeconomic stability take hold financial services providers can start to provide services that were unattractive in an unstable macroeconomic environment. Because savers would be more willing to hold long term assets, banks can issue longer-term deposit liabilities to fund term loans at fixed interest rates; corporate borrowers and government can issue long-term debt instruments. We will then enter a virtuous cycle of low inflation, low interest rates, high investment and high economic growth.

While we patiently await this adjustment of expectations, we cannot ignore the opportunities that exist even during this adjustment period. Financial risk exists even when there is macroeconomic stability. As long as we continue to live in a world of uncertainty, we have to deal with financial risk such as interest rate risk, exchange rate risk, commodity price risk and security price risk. Macroeconomic instability, however, magnifies financial risk and in the absence of appropriate risk management instruments economic growth is lower than what it might be with macroeconomic stability. Financial services providers can provide products to help manage the risks of users of financial services induced by macroeconomic instability. For example, how can a business that has borrowed on a floating rate basis hedge its interest rate risk? Products such as interest rate caps and collars and swaps could take the risk out of floating rate borrowing. However, financial institutions offering such products will in turn be able to hedge their interest rate risk if a simple interest rate futures contract and or option were available on our capital market. Similar opportunities exist to provide risk management instruments for the commodity, currency and equity markets.

Financial institutions must also take into consideration a multitude of forces that are interacting with the macroeconomic environment to change the financial services industry. These include the following:

1. Advances in information and computer technologies have made it possible for market participants and regulators to collect and process information they need to measure, monitor and manage financial risk; to price and trade complex new financial instruments and manage large books of transactions. Due to technological advancements, our local financial sector has undergone substantial changes becoming more dynamic and innovative. The number of new financial products and services has expanded dramatically.
2. Globalization of national economies has led many countries including Ghana to lower barriers to international trade and cross border flows of goods and services have increased significantly, stimulating demand for cross-border finance and in tandem with financial liberalization fostered the creation of an internationally mobile pool of capital.
3. The liberalization of national financial markets coupled with improvements in information technologies and globalization has catalyzed financial innovation and spurred the growth of cross-border capital movements.

4. Competition among the providers of financial services has increased because of technological advances and financial liberalization. Regulators have shown an increasing tendency to allow a broader range of institutions to offer financial services and new classes of financial institutions have emerged. Securities firms, asset managers, mutual funds, insurance companies, finance houses are increasingly providing services similar to those traditionally provided by banks.

These changes are leading to dramatic changes in the structure of national and international capital markets. Developments in other countries portend what is likely to happen in Ghana.

Financial Disintermediation

First banking systems in Ghana will go through a process of disintermediation – that is, a greater share of financial intermediation will take place through tradable securities rather than bank loans and deposits. In Ghana are that we now have, 20 licensed asset managers, 14 stockbrokerage companies, 8 mutual funds/unit trusts and 29 nonbank financial institutions.

In 2004, the Ghana stock exchange registered a record number of new listings with BOPP, CAL Bank, Clydestone, Starwin, raising a total of ₵159.3 billion in new capital. An additional ₵67.2 billion was also raised during the same period through rights issues by companies already listed. Intensified disintermediation can be expected as the capital market deepens and new forms of direct financing such as what is envisaged in the proposed government-sponsored venture capital scheme emerge.

All participants in the financial markets are playing a major role in this transformation and indeed stand to benefit from this transformation. There are indeed great opportunities for banks in this disintermediation. In other economies where the disintermediation is far advanced, banks have increasingly moved financial risks (especially credit risks) off their balance sheets and into securities markets – for example, by pooling and converting assets into tradable securities and by offering risk management instruments such as swaps and other derivative transactions. Companies and other borrowers have tended to rely more and more on capital markets. Finally a growing and more diverse group of investors have been willing to own an array of credit and other financial risks, thanks to improvements in information technology that have made these risks easier to monitor, analyze and manage.

Cross Border Activity

Second, cross border financial activity will increase. Investors will try to enhance their risk-adjusted returns by diversifying their portfolios international and borrowers including government will seek more flexibility by tapping markets and pools of capital in global financial centers. For example, as at

June 2004, the EPACK mutual fund operated by Databank had investments in 30 companies in Nigeria, Kenya, Botswana and South Africa.

Competition

Third, nonbank financial institutions are competing aggressively with banks for household savings and corporate finance mandates. They are garnering a rising share of savings, as households bypass bank deposits to hold their funds in higher return instruments – such as mutual funds – issued by institutions that are better able to diversify risks and take advantage of economies of scale and have grown dramatically in size as well as sophistication. As an early indication of the scale of what we can expect in terms of competition to mobilize savings, the value of assets held by 8 collective investment schemes in September 2004 stood at ₦456 billion. This is equal to the sum total of the deposits of Unibank, Metropolitan and Allied, Amalgamated Bank and International Commercial Bank. Databank's EPACK Fund stood at ₦246 billion as at June 2004 and exceeded the deposit liabilities of six out of 19 banks in Ghana. More importantly, the rate of growth is significant. From ₦70 billion in 2002, the sector's assets grew to ₦164.9 billion in 2003 before increasing to the present level.

Universalization

The growth and expansion of non-bank financial intermediaries, insurance companies, securities companies and mutual funds is forcing commercial banks to seek innovative ways to expand and diversify their operations in order to maintain their competitiveness and profitability. In this regard, commercial banks are increasingly diversifying into non-traditional financial activities such as leasing and insurance services. As a consequence, distinctions between commercial banks and other financial institutions are blurring. Commercial banks will expand beyond their traditional deposit-taking and balance sheet lending businesses as regulators increasingly allow universal banking to allow banks to enter investment banking asset management and even insurance, enabling them to diversify their revenue sources and business risks. The deepening and broadening of capital markets will create new sources of business for banks – the underwriting of corporate bond and equity issues – as well as new sources of finance as banks increasingly turn to capital markets to raise funds for their own investment activities. Banks will be forced to find additional sources of revenue including new ways of intermediating funds and fee-based businesses as growing competition from nonbank financial intermediaries reduces margins from banks' traditional businesses – corporate lending financed by low-cost deposits to extremely low levels.

How Prepared Are We?

The opportunities I have outlined above cannot be realized unless our regulatory framework adapts to accommodate the forces of change. Most of the legislation enacted during the first round of financial sector reforms in the

late 80s and early 90s have been overtaken by developments both at home and internationally.

- A new Banking Act has been passed but there is a need for a revised nonbanking law, Securities Industry Law and insurance legislation
- Financial sector regulation is fragmented. We have the Bank of Ghana regulating banks, rural and community banks and nonbank financial institutions, the National Insurance Commission, the Securities and Exchange Commission and a soon to be established Long Term Savings Commission. Limited regulatory resources as well as the convergence of financial services suggest that we make progress towards the unification of financial regulation under a single financial services authority. We could for a start consolidate the SEC, NIC and the LTS Commission before tackling the more challenging task of bringing banking supervision under the Financial Services Authority. This staged approach is how regulatory consolidation is being pursued in Mauritius. The Financial Sector Strategic Plan (FINSSP) makes strong recommendations on consolidation but large doses of political will will be required to make the leap.
- The concept of universal banking has to be elaborated further to enable banks to compete in a new world in which their dominant role will be increasingly contested by nonbank financial institutions. Under the Banking Act, 2004, banks are allowed to undertake many activities that go beyond traditional banking. These include:
 - Securities trading for own account or for the account of customers (i.e. brokerage)
 - Underwriting of new issues of securities
 - Portfolio management and advice
 - Any other services as the Bank of Ghana may determineThe clarification of universalization will require harmonizing the universal banking model with the mandates of the SEC and National Insurance Commission. For example, will banks be subject to SEC regulation when they engage in brokerage, underwriting and asset management?

Industry players also need to prepare themselves for the changes ahead. Banks have to prepare their senior managements to operate the new business model that universalization entails. Bank customer service representatives will have to be trained to offer a much wider array of financial services than traditional banking. Industry associations such as the Association of Bankers, Ghana Securities Industry Association and Ghana Insurers Association will have to collaborate better, perhaps offering associate memberships and/or observer status to each other.

Concluding remarks

We started by addressing the issue of the role of the macroeconomic environment in financial services and concluded that while we have made good beginnings, the battle for macroeconomic stability is far from won. In

particular, there is a need for policy credibility and consistency in order to stabilize the expectations of participants in the financial system. As expectations of stability materialize, we have the opportunity to issue longer term deposits and invest in longer-term assets. In the meantime, there is too much financial risk in the economy which itself presents opportunities for providing risk management instruments such as simple interest rate futures contracts which will provide a foundation for other risk management instruments such as interest rate caps, collars and floors.

Other forces will interact with the macroeconomic environment to present new opportunities. We can anticipate extensive disintermediation in deposit mobilization with the aggressive growth of unit trusts and mutual funds while a wide array of nonbank financial institutions will compete with banks to provide financing to businesses. We can anticipate that banks will become more universalized and will diversify their products to take advantage of a deepening capital market.

We cannot ignore the role of the regulator. Unless the regulatory agencies maintain the capacity to accommodate the changing environment while maintaining soundness, financial service providers will miss the opportunities that will emerge with improved macroeconomic stability, technological change and globalization. In particular, the consolidation of financial regulation and the clarification of universalization should engage the attention of regulators. Finally, the banking industry will need to master a new business model by building management and customer service capacity and industry associations have to work closely together.

I thank you for your attention.