POLICY BRIEF

Addressing the low level of competition and efficiency in the Banking Industry as a way to reducing cost of credit in Ghana

Summary

One of the main reasons for liberalizing the financial sector was to encourage competition, efficiency and reduction in cost of financial services. Yet, while the banking industry has seen the influx of foreign banks and introduction of new products with liberalization, cost of credit still remain high meaning, suggesting a level of competition in the banking industry. Using banking data from different sources, this policy brief discusses the level of competition in the commercial banking industry to draw policy implications in relation to cost of credit in Ghana. The argument is that the level of competition in the banking industry is still low as evidenced by the seemingly common prices charged by the banks, some form of concentration and insignificant differences in return on asset and equity. Furthermore, the intermediation process in most banks does not seem to be efficient thus, preventing banks from operating on the most efficient frontier which also adds to costs of operation. For policy purposes, the Bank of Ghana needs to allow competition to drive the banking sector, monitor the intermediation process of banks and ensure that banks reduce their prices following a downward revision of the Bank of Ghana policy rate.

Introduction

The banking industry in Ghana before 1983 was monopolized by state owned banks such as Ghana Commercial Bank, Agricultural Development Bank, Bank for Housing and Construction, National Investment Bank and a few others. Competition was rare so the notion was that liberalization of the financial system would breed competition. One of the reasons for liberalizing the financial sector in 1983 was to introduce competition into the baking and non-banking financial sector. Indeed, after 1983, the economy has witnessed the influx of foreign banks and more are yet to come. The liberalization of the financial sector under Financial Sector Adjustment Programme (FINSAP) and Financial Sector Strategic Plan (FINSSIP) also brought about improved savings, enhanced deposit mobilization, financial deepening and supposedly competition in the banking sector.

The new Banking Act of 2004 also brought some changes into the banking industry including elimination of secondary reserves and increase in minimum capital requirement among others. The number of Deposit Money Banks (DMBs), Non-Bank Financial Institutions (NBFIs), and the number of Rural and Community Banks (RCBs) remained at 27, 49, and 135 respectively of 2015 and this has not changed as of now.

Competition is a key driver of social welfare, as it may push down prices (i.e. interest rates) in the banking sector and improve services for consumers and enterprises (Cetorelli, 2001). Also, competition is pivotal to monetary policy in that in a competitive market, changes in the policy rates of the Bank of Ghana are passed on more quickly to the interest rates that banks offer their customers. It leads to efficiency through cost reduction and introduction of innovative products. Thus, any firm or organization which prevents competition either by preventing the establishment of more firms producing similar products or by colluding with existing firms in order to set identical prices higher than the perfectly competitive market price may not be following good business practices. Economists believe that vigorous competition coupled with strategic government regulation to reduce anti-competitive behaviour provide the most enabling environment for consumer welfare. However, recent studies have shown that in Sub-Sahara Africa where financial system is broadly bank-based is weakly contestable (Moyo et. al 2014) thus the system does not allow consumers enjoy the benefits of competition.

It is perceived that the influx of banks into the industry means the industry is competitive. Competitive nature of a firm is observed through pricing and control of output. The notion that the failure of one bank causes systemic panic that affects all banks is what motivates banks to co-operate than to become rivals. The interest rates charged by banks make people believe that there is some form of co-operation among commercial banks in Ghana. Even though the Bank of Ghana determines the prime rate which is the basis of building up interest rates, banks are allowed to set up their own base rates as well as the lending rates.

Elements of Competition

Product innovation

With the influx of foreign banks into the country, there is a variety of products that customers can choose from. In this regard one can confidently say that the banking sector has become competitive because competition should bring innovation. There are technological innovations with the introduction of automated teller machines (ATMs), electronic banking, mobile banking, telephone banking, SMS banking etc. These technological innovations have contributed largely to deepening banking services in Ghana. Banks' approach to dealing with Small and Medium Enterprises (SMEs) has also changed. Most banks have now set up SME desks in order to concentrate and provide specialized banking services to SMEs. In terms of these activities there is evidence to prove that the baking industry in Ghana has somewhat become competitive.

Market Share

Concentration in the Ghanaian banking sector is not consistent (Table 1). Able 1 indicates that between 2010 and 2013 there was up and down movements in concentration with the highest in 2012. As concentration in the Banking sector increases, bank lending channels weaken, causing monetary policy to be less effective and the transmission mechanism of monetary policy demonstrates low efficiency. In this brief we have tried as much as possible to remain anonymous in terms of the identity of the banks. Again, Bank A in Table 1 (for example) does not necessarily refers Bank A in Table 2 and so on but all the banks used in the study are existing commercial banks operating in Ghana.

Table 1: Market share- Operating Asset

Bank	**2013**	**CI**	**2012**	**CI**	**2011**	**CI**	**2010**	**CI**
A	12.9	166.41	12.4	153.76	10.2	104.04	8.8	77.44
B	9.4	88.36	11	121	11.8	139.24	12.3	151.29
C	8.2	67.24	6.5	42.25	5.6	31.36	5.3	28.09
D	8.1	65.61	8.7	75.69	9.6	92.16	9.7	94.09
E	5.5	30.25	3.6	12.96	3.4	11.56	3.8	14.44
F	4.7	22.09	5	25	5	25	3.9	15.21
G	4.5	20.25	2.7	7.29	2.8	7.84	2.3	5.29
H	4.4	19.36	5.3	28.09	5.6	31.36	5.5	30.25
J	4.4	19.36	12.3	151.29	3.7	13.69	2.8	7.84
K	3.6	12.96	3.5	12.25	3	9	3.7	13.69
L	3.4	11.56	3.2	10.24	2.5	6.25	2.1	4.41
M	3.4	11.56	3.2	10.24	3.8	14.44	3.8	14.44
N	3.2	10.24	3.9	15.21	3.8	14.44	3.9	15.21

O	2.7	7.29	2.2	4.84	2	4	2.1	4.41
P	2.6	6.76	2.9	8.41	1.3	1.69	1.1	1.21
Q	2.6	6.76	2.5	6.25	2.1	4.41	2.4	5.76
R	2.3	5.29	2.5	6.25	2.6	6.76	2.3	5.29
S	1.7	2.89	2.1	4.41	1.8	3.24	2.4	5.76
T	1.2	1.44	0.9	0.81	0.8	0.64	1.1	1.21
U	0.9	0.81	1.2	1.44	1.2	1.44	1.2	1.44
V	0.6	0.36	0.6	0.36	0.4	0.16	0.4	0.16
W	0.4	0.16	0.4	0.16	0.5	0.25	0.4	0.16
Sum of CI		**577.01**		**698.2**		**522.97**		**497.09**

Source: Computed from Annual Financial Statements of Banks (201-2013)
CI=concentration index

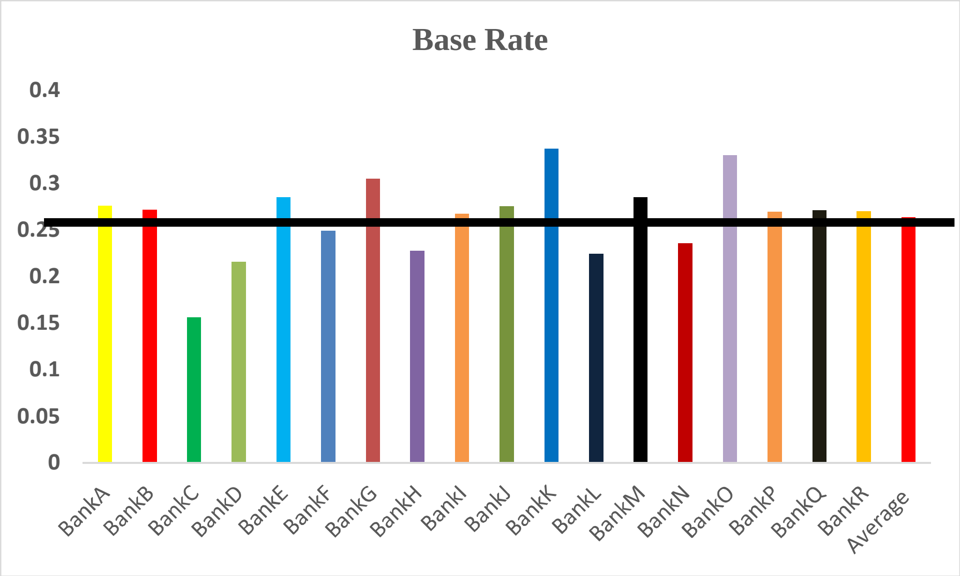
As of 2013 five (5) banks were controlling (44.1% market share) the banking industry. The makes the banking sector looks like leaders-followers market where the followers observe the behaviour of the leaders and follow suit their actions. This situation does not foster competition among the banks. The banking industry therefore seems to be oligopoly in nature because a few banks have close to 50% of the market share. One factor that has contributed to the increase in market share in recent times is the merger and acquisitions (M&A).

Market share is very influential in explaining spreads in Ghana and reflects the lack of price competition in the banking industry**.** Some studies have shown that concentration is associated with lower deposit rates and increase in concentration is associated with higher loan rates. Indeed, early studies often find a positive relationship between concentration and profits, which supports the assertion that market power is detrimental (Hannan, 1991).

Base rate

Base rate is the lowest rate at which a bank will charge interest. Also known as the repo rate, the base rate is set in line with the Bank of Ghana’s prime rate determined by the Monetary Policy Committee. This is done as a way to control inflation over the medium-term. The BoG has set guidelines for computation of base rates and annual percentage rates (APRs) of Commercial Banks in the Country. Banks in the country are therefore required to publish their BRs and APRs for the information of the public. This promotes transparency and also creates competition to the extent that it allows consumers to make informed choices about banks they would want to conduct business with. The publication of the base rates and APRs, however, is not strictly adhered to by all banks, thereby defeating the intended purpose. While the guidelines on the determination of base rates are meant to avoid unjustifiably high base rates, Bank of Ghana has directed that commercial banks cannot lend below their computed base rates. This directive seems to contradict the aim of lowering lending rates.

Figure 1: Bank base rates as of January, 2016



Source: Business Ghana, 2016 (www.businessghana.com)

In general banks charge interest at a stipulated figure 'above base rate', with the figure depending on all sorts of circumstances to do with the loan and the borrower. If the base rate rises, then usually the rate of interest charged on the loan will rise to preserve the differential and vice-versa. Hence, there is no significant evidence of price wars among the banks and that the kind of competition among Ghanaian banks and other SSAs is an impediment to the efficient operation of banks which has the potential for increasing the cost of credit through high margins (Bawumia, Belnye & Ofori, 2005; Ahokpossi, 2013).

Return on Equity and Asset

Return on equity (ROE) is the amount of net income returned as a percentage of shareholders equity and it measures a company's profitability by revealing how much profit the company generates with the fund shareholders have invested. The profit margin is also an expression of the amount of competition inherent in the business. Competitive industries tend to have a very low profit margin, since getting into those businesses is fairly easy. The case in Ghana is different because banks are known of making high returns due to high spreads.

Table 2: Industry ROE compared with individual ROEs (2009-2013)

Bank	**Mean Difference**	**Standard Errors**	**T-values**	**Pr (T)>t**
A	0.0189	0.0261	0.27	0.78
B	-0.0798	0.0647	-1.23	0.23
C	-0.0565	0.0654	-0.86	0.39
D	0.0882	0.0644	1.37	0.18
E	-0.1890	0.0574	-3.29	0.00 (Sig)
F	0.0592	0.0654	0.91	0.37
F	0.1591	0.0601	2.65	0.01 (Sig)

Computed from Annual Statements of Banks (2009-2013)

With the exception of two banks the rest are making similar return on equity (Table 2) in comparison with the industry average meaning performance measured by return on equity is not different across banks in Ghana. This may be as a result of similar rates that banks are charging assuming they all operate under similar conditions.

Table 3: Industry ROA compared with individual ROAs (2009-20013)

Bank	Mean Diff	SE	T-values	Pr(T)>t
A	-0.0022	0.0083	-0.03	0.79
B	-0.0092	0.082	-1.12	0.27
B	0.0011	0.0083	0.13	0.89
C	0.0069	0.0082	0.84	0.41
D	-0.0225	0.0074	-3.06	0.00 (Sig)
E	0.0018	0.0083	0.21	0.83
F	0.0242	0.0072	3.36	0.00 (Sig)

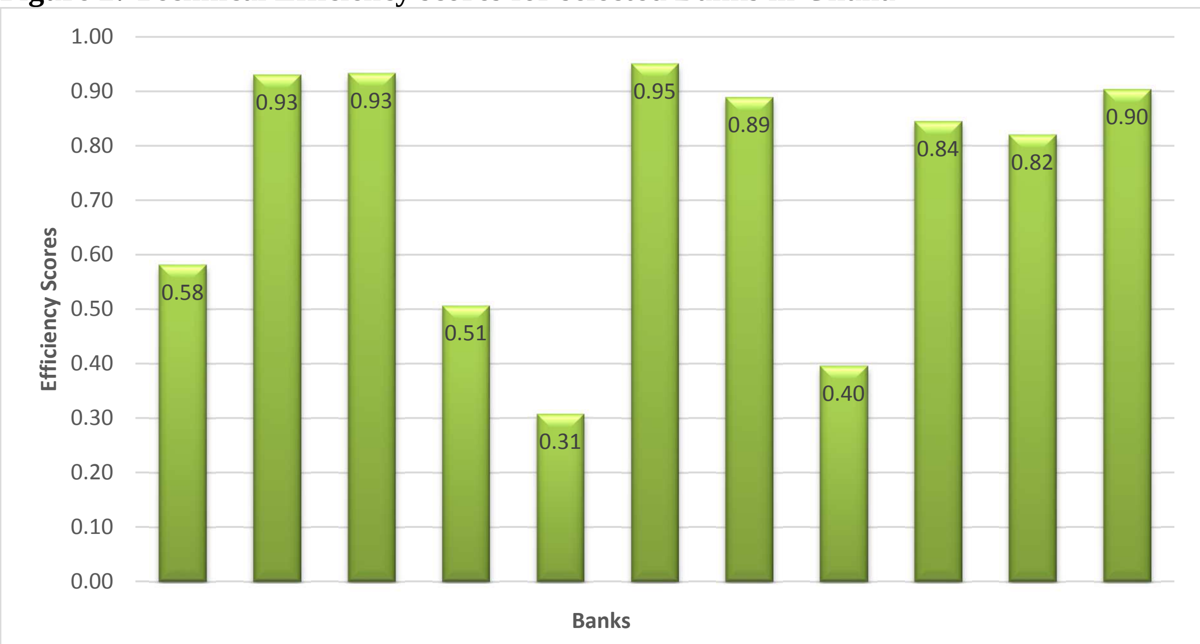
Computed from Annual Statements of Banks (2009-2013)

Similarly in terms of return on asset with exception of two banks the rest are making similar return on asset (Table 3) in comparison with the industry average meaning performance measured by return on equity is not different across banks in Ghana. This may be as a result of similar rates that banks are charging assuming they all operate under similar conditions.

Bank intermediation and Efficiency

High level of completion is supposed to make banks efficient. The efficiency of banks is witnessed in the intermediation process (from deposit mobilization to on-lending). We model intermediation process using technical efficiency model and generate the efficiency scores (Table 2) of some major selected banks. Private Banks are more efficient compared with government owned banks. In general the average efficiency score for banks in Ghana is 73%.

Figure 2: Technical Efficiency scores for selected Banks in Ghana



Source: Graphed from Annual Financial Statements

Bank level characteristics (including net interest margin) and some macroeconomic indicators are regressed on the technical efficiency scores of the banks to determine the factors that influence efficiency of banks. Interestingly, controlling for other factors we observe a negative relationship between net interest margin and technical efficiency. At 10% level of significance, as net interest margin increases by 1% bank efficiency deteriorates by 128% all other things being equal. It stands to reason that an increase in deposit rate will increase bank efficiency and intermediation. Conversely, if banks in Ghana should decrease their lending rate they are likely to increase their efficiency levels. The implication is that high interest margins deteriorate bank efficiency in Ghana. The cost of bank intermediation is transferred to customers basically in terms of high lending rates which do not encourage businesses to take loans.

Conclusions and Policy Recommendations

Conclusions

The findings presented in this brief suggest that the level of competition in the Ghanaian banking industry does not seem to be effective. It shows that while the number of banks in the country has increased, and therefore has brought about variety of products from which customers can choose, there are no significant differences in the rates that banks charge thus making them non-competitive as the theory suggests. Rather, some anecdotal evidence of leadership-followership tendencies among banks in Ghana is observed. Evidence of price wars among banks and kind of competition among Ghanaian banks therefore implies an impediment to efficient operation of banks in the country. Thus, most banks are operating below the optimum as a result of high cost of intermediation.

Given that high market share signals low levels of efficiency there is the need for the regulator to look into the merger and acquisition of banks that is likely to increase market share of some banks. Mergers that are aimed at increasing market share through indirect capitalization should not be encouraged. The following are some suggested recommendations for policy makers in the country.

Policy Recommendations

For policy purposes the following recommendations are necessary:

1. Bank spread needs to be reduced either by reducing lending rate or increasing deposit. This calls for guidelines on setting interest charges on loans and deposits.
2. The Banking Act needs to spell out the full rules regarding mergers and acquisitions of banks which has implications for high concentration.
3. Conscious effort needs to put place in terms of regulatory policies that will promote competition instead of allowing regulation to determine banking business in Ghana.
4. Publication of annual percentage rates (APRs) in the dailies needs to be enforced.
5. A policy on cost of credit is necessary to ensure the implementation of the above recommendations.

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