CENTRE AFRICAIN D'ETUDES SUPERIEURES EN GESTION

Sous-Direction de la Documentation (SDD)
Le Sous-Directeur
CESAG

Institut de Banque et Finance

Mastère en Banque et Finance

5ème Promotion

MEMOIRE DE FIN D'ETUDES

THEME

BANKING SUPERVISION IN GHANA: A DILEMMA OF VALUE AND COSTS?

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DECLARATION

I, Seth Selorm AWUTTEY, do hereby declare that this project work is entirely my own. It has not been submitted for any degree or certificate at any institution of higher learning or university. I have credited specific quotations and ideas to appropriate authors and institutions. I however take full responsibility for any errors, inaccuracies, or deficiencies in this work.

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DEDICATION

This project work is dedicated to my wife – Clarice, and my children – Emefa, Vera, and Elikem who had to bear the hardship of my absence to pursue further studies. The study is also dedicated to the suffering masses of Africa and it is my prayer that **GOD THE ALMIGHTY** will alleviate their plight.

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ACKNOWLEDGEMENT

I hereby wish to acknowledge the contributions and support of all those who in divers ways have contributed to the completion of this project work.

To **GOD ALMIGHTY**, for my life and **HIS** blessings throughout and beyond this work.

My profound gratitude goes to my supervisors, Messrs Dela V. Selormey (Deputy Head, Banking Supervision Department of the Bank of Ghana) and Wisdom A. Gagakuma (Senior Lecturer at the Ghana Institute of Management and Public Administration – GIMPA) for their time, suggestions, advice, and constructive criticisms, without which this project work would not have been completed.

I also wish to thank my beloved family, Clarice (my wife), Emefa, Vera, and Elikem (my children) for their encouragement, support, and prayers. I am also indebted to my brothers and sisters – Mathias, Micheal, Olivia, Regina, Charlotte, and Faustina for their prayers and support. My sincerest gratitude goes to my in-laws, Mr. and Mrs. Gilbert Kodjotse and my friend, Samson Fenuku for their encouragement and prayers before; during and after the programme.

My special thanks go to Mrs. Clarissa Kudowor and all the other staff of the Banking Supervision Department of the Bank of Ghana and staff of the MBF Project Office at the Centre Africain d'Etudes Supérieures en Gestion (CESAG), Dakar (Sénégal) for their contributions to the completion of this project work.

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ABSTRACT

The last decade of the 20th century witnessed banking crisis and bank failures in most of the key emerging and developing economies, especially in Africa and East Asia and created some form of macroeconomic instabilities in these affected economies. It must be noted that the banking crises and bank failures also hit some of the developed economies such as the United Kingdom, United States of America, Norway, Sweden, and Spain but they were able to deal with it decisively because of their earlier experience of the 1930s (Great Depression) and their current mature state of development.

The Ghanaian economy also experienced financial sector crisis in the early to late 1980s and had to undergo financial sector reforms in streamlining the banking sector in Ghana. The bedrock of Ghana's financial sector reforms was the strengthening of the capacity of the Banking Supervision Department, the promulgation of the Banking Law, 1989, Provisional National Defence Council Law (PNDCL) 225 and other institutional reforms. Despite these reforms, the country witnessed its first liquidation of three commercial banks (Bank for Housing and Construction, Cooperative Bank Limited, and Bank for Credit and Commerce International Ghana Limited) in 1998 as a result of internal control weaknesses.

In 2004, the Government on the advice of the regulatory authorities (Bank of Ghana) replaced the Banking Law of 1989 (PNDCL 225) with a more rigorous Banking Act, 2004 (Act 673), which seeks to correct the weaknesses of the Banking Law of 1989, (PNDCL 225). This study provides empirical evidence on the contribution of the Banking Supervision Department after the financial sector reforms in ensuring a safe and sound banking industry in Ghana despite resource constraints.

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We used the questionnaire and unstructured interview instrumentation for data collection and descriptive statistics methodology for data analysis, which was guided by recent theories of banking regulation and supervision as well as theories on banking crisis and bank failures.

The study reveals a deepening of financial intermediation and satisfactory growth in the asset base of the banking industry (21 banks at the end of year 2005) in Ghana during the period 2000 to 2005. Profit before tax also showed improvement year-on-year for the period under review (2000 – 2005). Banking industry in Ghana has been stable during the period under review, as a whole, remained well capitalised and liquid, with the brightest opportunities despite increasing competition brought about by the establishment of new banks. Borrowing rates and lending rates showed declining trend during the period under review.

These positive developments in the banking industry in Ghana was also underscored by the effectiveness of the Banking Supervision Department and a more focused and well-drafted Banking Act, 2004 (Act 673). The overall empirical evidence is consistent with the likelihood that the more rigorous United States of America's model of Banking Supervision, which is being adopted in Ghana to a large extent, requires a lot of resource commitment.

Despite the effectiveness of the Banking Supervision Department of the Bank of Ghana in ensuring that the banking industry is safe and sound, the empirical evidence reveals the need for the establishment of credit rating agency, deposit insurance institution, and credit register/bureau in Ghana to provide a more rigorous support to minimising the overall risk profile of the banking industry in the country. The study also reveals that the Bank of Ghana may not be entirely politically independent.

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The author believes that the study has made significant contribution to existing knowledge on banking regulation and supervision and at the same time unearthed some key structures lacking in the overall financial services industry in Ghana.

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La dernière décennie du 20ème siècle a connu des crises bancaires et des faillites des banques dans les pays clés émergents et les pays en voie de développement, surtout en Afrique et en Asie. Les crises ont créé des instabilités macro-économiques dans les pays affectés. Les problèmes des crises bancaires ont également affecté des pays développés, à savoir le Royaume Uni, les Etats-Unis, la Norvège, la Suède et l'Espagne mais l'impact n'était pas si grave que dans les pays émergents parce que ces pays développés ont déjà subi des conséquences et l'expérience de la grande crise bancaire des années 1930.

L'économie du Ghana a aussi subi les crises bancaires des années 1980 et par conséquent le gouvernement a mis en place des politiques réglementaires visant à corriger des faiblesses et à s'assurer du fonctionnement durable du secteur bancaire. En outre, dans le cadre d'appui le secteur bancaire au Ghana, le gouvernement a mis en place des dispositifs, à savoir le renforcement de la capacité du Service de la Réglementation et de la Surveillance de la Banque Centrale, la promulgation d'une nouvelle loi bancaire de 1989 (la loi 225), et les autres réformes structurelles. Malgré les réformes, l'économie du Ghana a connu la tombée en faillite pour la première fois de trois banques primaires (les banques créatrices de monnaie), à savoir la Bank for Housing and Construction, Cooperative Bank Limited, and BCCI Ghana Limited en 1998. Les trois banques sont tombées en faillite à cause des faiblesses de leurs politiques du contrôle interne.

Suite à la recommandation des autorités monétaires, le gouvernement a remplacé la loi bancaire de 1989 (la loi 225) par une autre loi de 2004 (la loi 673) qui vise à corriger les faiblesses de la loi de 1989 ainsi qu'à régler et contrôler le secteur bancaire. Cette étude a pour objet d'examiner la contribution apportée par le Service de la Réglementation et de la

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Surveillance (l'équivalent de la Commission Bancaire de l'Union Monétaire Ouest Africaine) dans le secteur bancaire au Ghana malgré les contraintes des ressources. En effet, la contribution positive du Service de Réglementation et Surveillance prouve que le secteur bancaire au Ghana est « sain et sauf » dans le cadre de l'objectif des autorités monétaires.

Nous avons fait recours au questionnaire et aux entretiens non structurés en collectant les données. En analysant les données nous avons employé les statistiques simples. Cette approche est influencée des théories de la réglementation et surveillance bancaire ainsi que les théories dans les cadres des crises et faiblesses bancaires.

L'étude montre que l'intermédiation financière et les actifs bancaires (21 banques à fin 2005) ont connu une forte croissance durant la période 2000 à 2005 au Ghana. Les résultats avant impôts ont également connu une amélioration pendant les années susdites. Le secteur bancaire restait stable, bien capitalisé, et liquide avec des opportunités malgré la compétition, menée par l'établissement des banques nouvelles. Les taux d'intérêt créditeurs et débiteurs ont connu une tendance décroissante pendant la période susdite.

L'économie du Ghana a connu ces développements positifs grâce à l'efficacité du Service de la Réglementation et de la Surveillance et la nouvelle loi bancaire de 2004 (la loi 673). L'étude montre aussi que l'optique de la réglementation et surveillance bancaire des Etats-Unis adoptée au Ghana requiert l'utilisation de beaucoup de ressources.

Malgré l'efficacité du Service de Réglementation et Surveillance de la Banque Centrale du Ghana en s'assurant du fait que le domaine bancaire soit « sain et sauf », nous avons constaté l'importance et l'établissement d'une agence de notation de crédit, «deposit

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insurance institution», et les centrales des risques au Ghana. D'après la revue de la littérature, ces trois institutions soutiennent le secteur bancaire dans le cadre de la minimisation des risques. L'étude montre également que la Banque Centrale du Ghana n'est pas entièrement politiquement indépendante.

L'auteur pense bien que cette étude a fait des contributions à la connaissance et au savoir-faire existant au secteur bancaire ainsi que dans le domaine de la réglementation et surveillance bancaire au Ghana. Elle montre également des défis du secteur bancaire que les autorités monétaires doivent relever pour améliorer davantage le développement du secteur bancaire au Ghana.

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LIST OF ABBREVIATIONS

BCCI: Bank for Credit and Commerce International

BSD: Banking Supervision Department

CAR: Capital Adequacy Ratio

CESAG: Centre Africain d'Etudes Supérieures en Gestion

FCFA : le Franc de la Communauté Financière Africaine

G10: Group of 10

GDP: Gross Domestic Product

GIMPA: Ghana Institute of Management and Public Administration

IMF: International Monetary Fund

MBF: Mastère en Banque et Finance

NLCD: National Liberation Council Decree

PNDCL: Provisional National Defence Council Law

UK: United Kingdom

USA: United States of America

US$: United States dollar

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CHAPTER 1

OVERVIEW OF THE STUDY

1.1 Background

The financial services industry across the globe witnessed mixed phenomenon in the 20th century. It was a century plagued with the worse financial crisis and bank failures so far in the history of developed, developing, and emerging economies. The failure of 10,000 banks in the United States of America (USA) alone between 1930 and 1933 made the Great Depression much deeper and long-lasting than it might otherwise have been. This led to the extensive USA deposit insurance scheme and its associated regulatory framework[1]. In 1995, the oldest and the largest merchant bank in the United Kingdom (UK), the Barings Bank was brought down through speculation in the Nikkei stock index and Japanese government bond failure.[2] The Asian financial crisis of 1997/98, though inextricably linked to domestic macroeconomic and financial developments, has put the spotlight on the structural features of financial system. A study by Lingren et al (1997)[3] has shown that two thirds of member countries of the International Monetary Fund (IMF) have been hit by severe banking crises.

On the positive side, the last decade of the 20th century was marked with significant growth and improvements in information communication and technology, which has contributed immensely to closer integration of the financial systems of both developed and developing economies. Various studies (Goldsmith 1955, Cameron 1967, Mckinnon 1973)[4] have demonstrated that financial sector plays a key role in economic development of countries and

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[1] La Ware, J.P. (1994), " Bank Failures in a Sound Economy", quoted in Sheng, A. (1996), Bank Restructuring: Lessons from the 1980s, The World Bank, Washington D.C., 1996, p.1.

[2] Sheng, A. and A.A. Tannor (1996), "Ghana's Financial Restructuring, 1983-91", Bank Restructuring: Lessons from the 1980s, The World Bank, Washington D.C., 1996, pp.123-132.

[3] Lindgren C. J., Garcia G., M.E. Saal, "Bank Soundness and Macroeconomic Policy," IMF, Working Paper, 1996.

[4] Emenuga, Chidozie, "The Outcome of Financial Sector Reforms in West Africa", http://www.idrc.ca/en/ev-56356-201-1DO_TOPIC.html, p.1. (accessed on January 30, 2006).

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could therefore be a catalyst for economic growth. At the core of the global financial systems' integration is the critical roles of financial intermediation and management of both national and international payment systems played by commercial banks. Banks represent a vital link in the transmission of government economic policies, particularly monetary policy and to that extent, their roles affect the lives of many individuals, business entities, and governments.

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Recent research[5] reveals that banks matter for human welfare and economic growth. The importance of banks is most often noticed when they fail. Indeed, the fiscal costs of banking crises in developing countries since the 1980s were estimated at over US$1 trillion. Theoretically, banks mobilise and allocate savings efficiently in return for highest expected return. They then exert sound governance over the funded entities to foster innovation and growth and in the process assist in poverty reduction and income distribution. This important relationship between banks and economic welfare has led international institutions, policy makers, and researchers to develop policy recommendations concerning bank regulation and supervision. Indeed, the International Monetary Fund, The World Bank, The Bank for International Settlements, and other international organisations have developed extensive checklists of "best practice" recommendations for banking institutions that they urge all countries to adopt.

Banking is a business of risks. There is a risk in every transaction a bank undertakes and in every service it provides. The number, nature, and magnitude of risks that banks run in the course of their businesses develop very rapidly as financial and operational technologies evolve and financial systems become more liberalised and global. Most transactions that

[5] Levine Ross, (2005), "Bank Regulation and Supervision," http://www.nber.org/reporter/fall05/levine.html,, p.1. (accessed on March 17, 2006)

banks undertake are subject to one or more of the following risks – credit, country and transfer, market, interest rate, liquidity, and operational.[6]

Paradoxically, and contrary to what pertains in other industries, banks fund their major and most risky asset (loans and advances) with depositors' funds. By the nature of banking business – trust and confidentiality – depositors do not have much information about risks to which their monies are put. Most often than not depositors have opportunity of reviewing a bank's performance once a year as contained in annual report, which is not comprehensive enough to portray a bank's risk profile. Consequently, it becomes very imperative to regulate and supervise banks in such a way that while they strive to contribute to human welfare, economic growth, and maximise shareholders' value, they do it in such a professional manner that the depositors and the entire economy do not suffer. Bank regulators and supervisors therefore fill that gap that exists between depositors and banks to provide that "assurance" that banks conduct their business in a transparent manner, that depositors' funds are protected, and that the entire banking industry is sound and healthy. By the nature of their role and functions, bank regulators and supervisors will have to add a lot of value to the business of banking through the process of risk identification, monitoring, and enforcing compliance through risk minimisation limits. The effectiveness and efficiency of this process entail a lot of resource commitment and utilisation on the part of bank regulators and supervisors.

In Ghana, the Banking Act, 2004 (Act 673) confers statutory powers and functions on the Bank of Ghana to have an overall supervisory and regulatory authority in all matters relating to banking business in Ghana and shall be responsible for "*promoting an effective banking system; dealing with any unlawful or improper practices of banks; and considering and*

[6] Basel Committee on Banking Supervision, "Core Principles for Effective Banking Supervision", October, 2006.

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proposing reforms of the law relating to banking business" among others. In addition, the Banking Act 2004 (Act 673) enjoins the Bank of Ghana to establish within its organisation, a Banking Supervision Department to exercise powers conferred on the Bank of Ghana under the Banking Act 2004 (Act 673) concerning banking business in Ghana. The key functions of the Banking Supervision Department under the Banking Act 2004 (Act 673) include licensing of banks, market conduct, regulatory reforms, issuing directives, conducting on-site examination, and off-site supervision of banks.[7] This statutory responsibility of the Banking Supervision Department in Ghana to add value to the banking business in Ghana with consequential cost ramifications therefore set the tone for this study worthwhile.

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1.2 Statement of the Problem

Over the recent years, it has become apparent that financial markets have become more volatile. As the pace of change increases, aided by the advancement in the information communication and technology, and financial institutions become larger, more international and more complex, the tasks facing bank supervisors becomes increasingly challenging. According to the Basel Committee on Banking Supervision's Working Paper No. 13 (April 2004) captioned "*Bank Failures in Mature Economies*"[8], many highly developed economies that have even sophisticated markets and long functioning banking systems have had significant bank failures or banking crisis during the past 30 years. The banking crisis that swept through East Asia in 1997/98, set off dramatic recessions in the affected countries and imposed heavy costs on the domestic taxpayers. In order to minimise and/or prevent future bank failures and lessen/minimise the cost of bank failures, central banks have implemented numerous legal and regulatory changes in the affected countries.

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[7] Part I, Part II, and Part VII of the Banking Act of Ghana, 2004, (Act 673).

[8] http://www.bis.org/publ/bcbs_wp13.htm, pp.1-3, 66-69, (accessed on March 16, 2006).

According to Noy (2005)[9], the estimated cost of the Indonesian banking crisis to the country's taxpayers was US$75 billion and that of the Thai banking crisis (1997-2002) was estimated to be a staggering 35% of gross domestic product (GDP). In Ghana, the Government had to inject ¢90 billion in the year 2000 to pay off depositors and employees of two liquidated banks - Bank for Housing and Construction and Cooperative Bank Limited[10]. The main rationale for these bail-outs was to minimise the adverse effects on public confidence in the banking system, which is a critical success factor in banking business. The failures of Baring Bank and Bank of Credit and Commerce International (BCCI) in the UK have been very significant to the extent that the liquidators (Deloitte and Touche) acting on behalf of depositors of BCCI sued the Bank of England in 1993 (the supervisory Authority at the time of collapse of BCCI) for about £1 billion damages claim for knowingly or recklessly failing in its supervisory role to protect depositors. Though the case was finally dropped in November 2005 after going through several hearings, it presents an interesting eye-opener for the role, responsibilities, and challenges of banking supervisory authorities in their quest to ensure safe and sound banking industry in the light of constrained resources[11].

One of the most common assertions within literature is that recent liberalisation of the domestic financial sector and lax supervision was found to significantly increase the likelihood of a banking crisis (Noy, 2004).[12] According to Basle Committee on Banking Supervision,[13] lax regulatory systems and poor supervision were found to have contributed to bank insolvencies in both developing and developed countries. It may therefore be noted that banks are highly sensitive to changes in their regulatory environment and significant changes

[9] Ilan Noy (2005), "Banking Crises in East Asia: The Price Tag of Liberalization?" http://www.eastwestcenter.org/stored/pdfs/api078.pdf, pp. 2-8 (accessed on March 17, 2006).
[10] Apea, S.K. (2000), "The Repercussions of the Liquidation of the Bank for Housing and Construction, and the Cooperative Bank Limited", Governance, Vol.2000, No.03155N 0855-2452, February 2000, pp.3-4.
[11] http://news.bbc.co.uk/go/pr/fr/-/2/hi/business/4399336.stm (accessed on March 22, 2006).
[12] Ilan Noy (2004), Financial Liberalization, Prudential Supervision, and the onset of Banking Crises, http://www2.hawaii.edu/~noy/papers/banklib.pdf, pp. 341-359 (accessed on March 22, 2006).
[13] Bank Failures in Mature Economies, Working Paper No. 13 (April 2004), pp.1 and 66.

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in this environment weaken them and may lead to severe crises. Secondly, because banking systems have a strategic role in an economy, their malfunctions may have negative externality effects on the entire financial system and the economy. This underscores the crucial importance of prudential monitoring of banks in order to ensure effective control of the banking system. The problem statement of the study, which draws heavily on the foregoing, is therefore outlined below:

(a) The Banking Supervision Department of the Bank of Ghana might lack the required calibre of staff to effectively supervise banks and therefore protect the interest of depositors in view of the rapid and sophisticated changing banking environment;

(b) The Bank of Ghana might not have the legal power to resist Government interference in discharge of its professional work to appropriately apply sanctions and penalties on the commercial banks where necessary; and

(c) The Banking Supervision Department might be constrained by resources to adopt minimal approaches to regulating and supervising commercial banks in Ghana to the detriment of the depositors in particular and the entire economy in general.

The above problem statements were situated in the context of the ensuing study objectives.

1.3 Objectives of the Study

The last decade of the 20th century witnessed a lot of systemic banking crises (Lindgren, Gracia, and Saal, 1996; Caprio and Klingebel, 1996).[14] The economic crises experienced by five East Asian countries namely Indonesia, Malaysia, Philippines, South Korea, and Thailand were accompanied by deep financial sector problems. According to Dr. Paul A. Acquah, the Governor of the Bank of Ghana, the problems were foreseen in some cases whilst in others

[14] Speech on " Sensitisation Seminar on Financial Soundness Indicators" by the Governor of the Bank of Ghana, Dr. Paul A. Acquah (on March 3, 2005), http://www.bog.gov.gh, pp.1-2 (accessed on January 28, 2006).

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most observers, including the International Monetary Fund, The World Bank, and the major credit rating agencies were caught by surprise. The main objectives of this study were therefore to:

(a) Assess the extent to which depositors' funds are protected;

(b) Assess the adequacy of the Banking Supervision Department's capacity to effectively and efficiently supervise banks in Ghana in view of the rapid and complex changing banking environment;

(c) Find out the type of supervisory model used by the Banking Supervision Department of the Bank of Ghana;

(d) Assess the extent to which the Banking Supervision Department is strategically positioned and insulated from political interference to carry out its functions and responsibilities effectively;

(e) Assess the existence, application, and relevance of financial soundness indicators for monitoring risk and performance profile of banks in Ghana;

(f) Review the adequacy of risk identification and monitoring mechanisms used to oversee the operations of commercial banks;

(g) Evaluate the financial health and soundness of the banking industry in Ghana; and

(h) Review the adequacy of the Banking Act, 2004 (Act 673) as a fundamental banking regulatory framework in Ghana.

The objectives of the study are very important because of the crucial role banks play in economic development of developing countries such as Ghana. Banks are the core of the financial system in developing countries. Knight, (1999)[15] asserts that banks play even larger role in financing economic activity in developing countries than they do in many developed

[15] Knight, M. (1999), "Developing and Transition Countries Confront Financial Globalisation", Finance and Development June 1999 pp.32-35.

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countries. In many developing countries, insurance companies and other non-bank financial institutions are few and are in the early stages of development, and domestic bond and stock markets are still relatively small relative to the economic activities. A World Bank Report on Ghana (1994)[16] also notes that the banking system is the core of the Ghanaian formal financial system because it accounted for about 80% of total assets in the financial system, excluding those in the Bank of Ghana.

1.4 Scope of the Study

The study focused on the operational activities and structures of the Banking Supervision Department in Ghana. It also covered the Banking Act, 2004 (Act 673) as a key regulatory framework of banks in Ghana. The study employed financial data and information on the banking industry (excluding rural/community banks) in Ghana for the period 2000 to 2006.

1.5 Significance of the Study

The study is relevant in view of the ramifications of the recent banking crises that plagued some developing and emerging economies, especially the East Asian countries in the early and late 1990s. The study is also significant in view of the liquidation of three commercial banks in Ghana in the year 1998 due to internal control weaknesses after the country had undergone financial sector restructuring. The study provide some insights into future direction of banking supervision in Ghana and has contributed to literature on banking and banking supervision in Ghana and the West African sub-region, especially the Anglo-Saxon approach to banking supervision. It would also be of importance to lecturers, students, bank regulators, bankers, policy-makers, and the general public in their quest for additional knowledge relating to banking regulation and supervision, especially in Ghana.

[16] World Bank (1994), "Ghana, Financial Sector Review: Bringing Savers and Investors together ", Report No.13423-Ghana, December, 1994, pp.49-51.

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1.6 Limitations of the Study

Resource constraints (financial and time) did not permit the study to solicit views from the supervised banks. It is likely that the non-inclusion of the views of the supervised banks might open some of the findings and conclusions of the study to critique. Some analyses of the study were based on trend and relationships using financial ratios derived from secondary data on the banking industry in Ghana. In spite of the relevance of financial ratios in providing insightful guide to management decisions, they are also based on historical cost information, which could lead to inaccurate findings and conclusions. Ratios are nothing more than numerical relationships in financial statements at a moment in time and therefore may not necessarily provide expected result (Kieso, Weygandt and Warfield, 2001)[17].

Readers are also reminded that the respondent did not provide answers to some of the questions in the questionnaire on the basis of confidentiality, which those questions sought to bring to the public domain. Furthermore, the study did not seek to reveal the strengths and/or weaknesses of each individual bank but rather focus on the banking industry as a whole.

1.7 Organisation of the Study

The study is organised into six chapters. The first chapter looked at the overview of the study, which dealt with the background, statement of the problem, and the objectives of the study. It also contained limitations, significance, and organisation of the study. The second chapter deals with theoretical foundation (literature review) whilst chapter three covers banking industry in Ghana. Chapter four deals with research methodology while chapter five covers data analysis and interpretation. Chapter six recapitulates the findings of the study with recommendations and conclusion.

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[17] Kieso, D.E., J.J. Weygandt, and T.D. Warfield (2001), Intermediate Accounting, 2001, 10th Edition, Elm Street Publishing Services, Inc. p.1413-1420.

CHAPTER 2

THEORETICAL FOUNDATION

2.1 Definition of Banking Regulation and Supervision

A smoothly functioning banking regulatory and supervisory regime is one of the cornerstones of any financial system. Only a safe and healthy financial system, which is one of the key aims of a central bank's regulation and oversight, can optimally fulfill its macroeconomic function and objective of efficient and low-cost transformation.

According to Llwellyn (1986)[18], regulation of banks refers to a body of specific rules or agreed behaviour either imposed by government or other external agency or self-imposed explicit or implicit agreement within the industry that limits the activities and business operations of banks. Regulation is therefore the codification of public policy towards the operations of banks to achieve a defined objective and/or act prudently. The above definition presents banking regulation in two folds – the enactment or establishment of rules of behaviour and the ultimate compliance with the rules by regulated banks. Supervision on the other hand, is the process of monitoring banks to ensure that they carry out their activities in a safe and sound manner and in accordance with established laws, rules and regulations at all times. Supervision can therefore be described as the more general observation of the behaviour of a bank. However, it must be noted that in literature[19] the distinction between bank regulation and supervision is often not explicitly made and these terminologies are often used interchangeably.

[18] Llwellyn, D.I. (1988), The Regulation and Supervision of Financial Institutions, The Institute of Bankers, London, quoted in a paper presented by Alashi S.O. "Banking Supervision Under West Afriacan Monetary Zone", http://www.cenbank.org/out/efr/2002/efrvol40-4-5.pdf#search="banking%20supervision%20, pp.70-89, (accessed on April 3, 2006).

[19] Ligeti, Sandor (2001), "Banking Supervision", http:/www.lib.uni-corvinus.hu/gt/2001-1-2/ligeti.pdf, p.47 (accessed o April 4, 2006).

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2.2 Objectives of Banking Regulation and Supervision

The question of regulation of banks has been discussed by academics, economists and bankers for years. There are some economists who state that banking regulation is not needed because market imperfections and failures do not exist, regulation is too expensive and moral hazards appear. However, bank failures and bankruptcies in recent years and recent developments of financial markets (e.g. globalisation, financial innovations, financial conglomerates) raise the question of the need for banking regulation and supervision.

Banks worldwide are more regulated than any other financial institutions because of their crucial roles in financial intermediation and payment systems. As financial intermediaries, banks mobilise funds from the surplus spending units at a cost for lending to the deficit spending units at a price both within and outside the shores of a country. In discharging their financial intermediation role, it is the responsibility of banks to ensure that the funds mobilised could be accessed by the depositors as and when needed. Banks also provide smooth and efficient system for making payments to settle both business and personal transactions, and international financial obligations on behalf of their customers. Schumpeter (1934)[20] asserts that banks are necessary condition for economic development. This assertion has been supported by several later scholars including Goldsmith (1969)[21] and Cameron (1972)[22] to the effect that there is a positive correlation between real output, investment, bank assets, and money supply. It is in recognition of this that John B. Heimann, founding Chairman of the Financial Stability Institute of the Bank for International Settlement in June

[20] Schumpeter, J.A. (1934), The Theory of Economic Development, Harvard University Press, Cambridge, Mass, quoted in quoted in a paper presented by Alashi S.O. "Banking Supervision Under West Afriacan Monetary pp. 70-89, (accessed on April 3, 2006).
[21] Goldsmith, R.W. (1969), Financial Structure and Development, Yale University Press, Cambridge, Mass, quoted in a paper presented by Alashi S.O. "Banking Supervision Under West Afriacan Monetary Zone", pp.70-89, (accessed on April 3, 2006). (accessed on April 3, 2006).
[22] Cameron, R. (1972), Banking and Economic Develpoment: Some Lessons of History., Oxford University Press, New York, quoted in a paper presented by Alashi S.O. "Banking Supervision Under West Afriacan Monetary Zone", pp.70-89, (accessed on April 3, 2006).

2001 asserted that "*the prosperity and strength of any economy relies heavily upon the proper and prudent functioning of the country's system of financial intermediation. If the financial system is strong, the economy has the ability to grow and the strength to absorb shocks. But if the financial system is weak, it acts as a magnifier of problems, rather than a shock absorber*".

Banking regulation and supervision are necessary because customers of banks do not have relevant information on financial institutions, cannot judge the safety and soundness of institutions when they make contracts with them and cannot follow up their activities and cannot realise when a bank becomes risky. Consequently, bank supervisors come in to fill this information gap (for example liquidity, profitability, solvency) between the customers and the banks in ensuring safety and soundness of banks.

Giddy (1984)[23] advanced the objectives of banking regulation and supervision as the protection of depositors because depositors have difficulty protecting their interest when compared to other bank creditors and investors. On his part, Sheng (1990)[24] refers to the objectives of banking regulation and supervision as:

i) promotion and development of sound and wide range of financial services to meet the needs of the economy;

ii) ensuring efficiency, security and responsiveness of banks to the needs and complaints of customers;

iii) ensuring compliance with laid down rules and regulations, which are germane to ensuring high standards of banking; and

[23] Giddy, I. H. (1984), The principles and Practice of Banking Supervision: Main Features and Evaluation and Possible Alternatives. Mimeo: IMF Central Banking Seminar, Washington DC.

[24] Sheng Andrew (1990), Bank Supervision: Principles and Practice, The World Bank, Washington, DC.

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iv) to achieve important developmental and social goals through compliance with monetary and credit allocation policies.

A paper by Jackson[25] highlights the wider costs to the economy if banks fail because of their central position in the payments system and their special role in intermediating funds to firms and the general public. Concerns that banks can pose threats to the entire economic system initially led to the development of lender-of-last-resort facilities, restricted in theory to solvent banks in liquidity difficulty, but over time have also led to the development of supervision of banks to reduce the likelihood of failure. Regulation is therefore a response to the gap between the private cost of failure of a bank and the public cost. But it is also a response to the moral hazard which comes out of other arrangements to protect the system or depositors. Extensive safety nets or deposit protection arrangements reduce the effectiveness of market discipline which is also affected by the substantial asymmetries of information between banks and the markets given historic cost accounts and between banks and their depositors. According to Jackson, the objectives of regulation and supervision of banks are premised on the following:

i) The potential externalities stemming from bank failures which mean that the social cost of failure is higher than the private cost - resulting from:

(a) Risks of contagion between banks exacerbated by the risk of runs given the nature of banks' deposit and loan contracts.

(b) The special role that banks play in the real economy because of their central role in the payments system and in lending to small business and retailers.

[25] Jackson Patricia, "Finance and Regulation Seminar Series at the Judge Institute of Management", http://www.cerf.cam.ac.uk/publications/files/Patrica%20Jackson.pdf, (accessed March 17, 2006).

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ii) The asymmetry of information between the market, depositors, and banks which reduces market discipline.

iii) Moral hazard caused by other mechanisms which have developed to deal with the problems in banks – lender of last resort and deposit protection.

The primary objective of banking regulation and supervision therefore includes maintaining a safe and sound banking system, promoting macro economic stability, protecting depositors' interest, and enhancing market discipline and transparency.

2.3 Banking Supervision Models

There is no theoretically optimal model or standard textbook blueprint yet for the structure and process of regulating and supervising financial institutions, including banks. In fact, arrangements for banking regulation and supervision differ from jurisdiction to jurisdiction. Apart from differences in political structures and practices, the most important factors that account for differences in regulatory and supervisory models and approaches include the general complexity and development of the banking system, the number, size and concentration of banking institutions, the relative openness of the domestic financial system, the nature and extent of public disclosure of banks' financial positions, and the availability and state of technological and human resources for bank regulation and supervision.

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However, the Basel Committee on Banking Supervision has developed (in 1997) an implicit framework for regulating and supervising banks known as *Core Principles for Effective Banking Supervision* (under revision). This framework can be interpreted as comprising four distinct yet complementary sets of arrangements:

i) legal and institutional arrangements for the formulation and implementation of public policy with respect to the financial sector, and the banking system in particular;

ii) regulatory arrangements regarding the formulation of laws, policies, prescriptions, guidelines or directives applicable to banking institutions such as entry requirements, capital requirements, accounting and disclosure provisions, risk management guidelines;

iii) supervisory arrangements with respect to the implementation of the banking regulations and the monitoring and policing of their applications; and

iv) safety net arrangements providing a framework for the handling of liquidity and solvency difficulties that can affect individual banking institutions or the banking system as a whole and for the sharing of financial losses that can occur (e.g. deposit insurance schemes or winding-up procedures).

The overall objective of this comprehensive process of supervision provided by the *Core Principles for Effective Banking Supervision* is to "guarantee" that banks can be established, efficiently operated, and restructured in a safe, transparent, and efficient manner. From this framework, three basic banking supervisory models evolved.

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2.3.1 British Model

In Britain, banking supervision was traditionally carried out by the Bank of England in consultation with banks, on informal approach basis[26]. Moral suasion, discretion, and personal contacts were the principal tools of bank supervisors. Banks made prudential returns but unlike other systems of supervision where bank supervisors conduct on-site examinations to verify and extract information, the responsibility for passing on information to the Bank of England rested solely with the commercial banks. The flaws of this approach became very evident when the banking system came under stress as the number of banks increased as a result of the creation of the so-called secondary banks and the influx of foreign banks in the late 1960s and early 1970s. Consequently, the British authorities adopted a more legalistic approach to bank regulation and supervision that brought the British model closer to continental European model. The British authorities then delegated on-site supervision of banks to external auditors by strengthening the reporting requirements of banks' auditors to the Bank of England (Financial Services Authority). The British model will seem to be ideal for economies with relatively small number of banks, a strong central authority, a tradition of close cooperation between government and industry as well as close personal relationships between commercial banks and supervisors, effective management systems, strong auditing and accounting practices, full disclosure to ensure market discipline, and a system built on trust and honesty.

2.3.2 Continental Europe Model

The model of bank supervision found in continental Europe is based on a legalistic approach that stipulates various ratios that banks must comply with but delegates the on-site supervision of banks and verification of their records to external auditors. In Germany, general auditors

[26] Polizatto, Vincent, "Building an Effective Framework for Bank Supervision", http://www1.worldbank.org/finance/PUBS/POLIZATT/poli001.htm, pp. 1-8, (accessed on March 13, 2006).

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carry out on-site examination of banks and must inform the regulatory authorities if they discover facts that justify the qualification of an audit. However, bank supervisors retain the rights to examine a bank's books and carry out examinations at anytime. The rationale is to ensure that the external auditors perform the supervisory functions with utmost professionalism. In Belgium, special auditors are appointed to perform on-site examination of banks and are paid by the regulatory authorities. In Switzerland, external auditors are licensed by the Federal Banking Commission and are subject to special statutory dudes. This model seeks to ensure that the external auditing firms employ and retain highly skilled staff and also stay above any influence from banks. The model however, has the potential of placing the external auditors in conflicting roles with dual loyalties to both the banks and the regulatory authorities in cases where the auditors are permitted to undertake other works. In addition, there is a concern that in their efforts to control costs and maximize profits, auditors may not devote sufficient resources to ensure proper performance of the audit.

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2.3.3 United States Model

The banking supervision model in the United States exemplifies the formal approach to supervision that requires an active, on-site presence to verify conditions existing within commercial banks. In the United States, the periodic on-site examinations have been the cornerstone of the supervisory process. This approach is justified by the large number of small banks within particular states but with geographical restrictions on expansion. Unlike the British and continental European countries where the regulatory authorities rely on outside experts such as external auditors, bank supervisors in the United States must themselves possess the skills to evaluate asset quality and other areas of a bank's operations. While this model gives a better satisfaction and assurance to the regulatory authorities, it is very labour intensive and can be inhibited by budgetary constraints.

While harmonization of the three models will seem to be ideal for ensuring maximum objective of banking regulation and supervision, it is equally important to recognize that it may have serious cost implications and budgetary constraints, which may require substantial sustained government support. At the core of this harmonized model is the availability and retention of highly skilled and experienced labour, adequacy of logistics, and independence of the regulatory and supervisory authorities from political influence.

2.4 Approaches/Methods to Banking Supervision

The overriding responsibility of bank supervisors in the broadest sense is to ensure that financial intermediaries are safe, sound, efficient, and honest. Consequently, and in order to achieve this fundamental objective, bank supervisors adopt two main but complementary approaches – on-site supervision/examination and off-site supervision/surveillance - to supervising commercial banks.

2.4.1 On-site Supervision/Examination

On-site supervision is a process of fieldwork surveillance adopted by regulatory and supervisory authorities to assess the quality of commercial bank's assets, funds management, management, earnings, capital, and compliance with laws, rules, and regulations, as well as the bank's internal control, audit, management information, accounting systems, and reliability of prudential returns submitted to the regulatory authorities. This approach affords bank supervisors the opportunity to ensure that the book value of a bank's assets is not overstated and liabilities understated. This is done through portfolio reviews, especially investments, loans/ advances, and funds management (liabilities).

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2.4.2 Off-site Supervision/Surveillance

The off-site supervision is concerned with on-going analysis of prescribed prudential returns submitted to regulatory authorities. The off-site supervision technique is used to monitor the performance of banks and also serve as a conduit for early warning signal indicators. The method monitors timing of submission of prudential returns, determination of accuracy and reliability of prudential returns submitted through statistical analysis. Prescribed financial ratios are computed for each bank and compared with past performance of each bank, peer group and the banking industry as a means of having a bird's eye view of a banks' performance. Supervisory authorities, which do not have the mandate or resources to carry out periodic on-site supervisions, rely extensively on this method to monitor financial condition and performance of banks and to identify those institutions that may need closer monitoring and scrutiny[27]. Polizatto (2001)[28] asserts that off-site supervision of commercial banks by the regulatory authorities provides an important complement to on-site supervision by providing early warning of actual or potential problems and also serves as a means for monitoring and comparing financial performance of commercial banks. Off-site supervision should be fully integrated into the supervisory process so that actual and potential weaknesses may be foreseen and remedial measures taken ahead of time. Polizatto holds the view that for off-site supervision to add value to commercial bank's performance, bank supervisors should have the ability to prescribe timing, content, and format of prudential returns so that comparative data can be prepared and used in a consistent fashion.

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[27] Sahajwala, R., and Van den Bergh, P., "Supervisory Risk Assessment and Early Warning Systems", Basel Committee on Banking Supervision Working Papers, No. 4 , December 2000, www.bis.org/publ/bcbs_wp4.pdf, p.3 (accessed March 16, 2006).
[28] Polizatto, Vincent P. "Building an Effective Framework for Bank Supervision", http://www1.worldbank.org/finance/PUBS/POLIZATT/poli001d.htm, pp.1-8 (accessed on March 13, 2006)

2.5 Banking Risks

The essence of bank regulators and supervisors exercising the utmost supervisory oversight over the commercial banks cannot therefore be over-emphasised because banks have to identify, control, and management unique risks inherent in the nature of their business. In the course of conducting its business, a bank comes across an array of unique risks. Bank risks arise primarily from the liability-assets transformation process. Banks mobilize liabilities at various maturities and interest rates and transform them into assets mostly credits (thus exposing them to credit risk) at various maturities and interest rates which are different from those obtained on the liabilities they mobilised in order to make gains. Managing the inherent maturity mismatches between the liabilities and assets through the transformation process gives rise to interest rate and liquidity risks and other related risks such as market risk, operational risks, legal and reputational risks. Risks are expanding dramatically and becoming much more varied as financial technology evolves and financial systems become more liberalized and global. As this happens, the importance of banks grasping and analyzing the locus and quantity of these risks of their own accord grows so is the need for them to properly manage these risks in their operations. These risks have the potential to affect financial performance and business reputations at the micro level. However, the entire spectrum of these risks must be effectively managed in order to prevent or at least minimize systemic risk.

The Basle Committee on Banking Supervision (Core Principles for Effective Banking Supervision, 2006)[29] has identified six key banking risks namely credit, country and transfer, market, interest rate, liquidity, and operational risks and made recommendations to assist bank supervisors in their supervisory process as represented in Table 2.1 overleaf:

[29] http://www.Bis.org.

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Table 2.1: Risks facing banks

Risk	Definition	Supervisory Principle
Credit Risk	Credit risk arises from the potential that a borrower or counterparty will fail to perform according to a contractual agreement.	Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.
Country and Transfer Risk	Country risk is the risk associated with the economic, social, and political environments of the borrower's home country. A transfer risk arises when a borrower's obligation is not denominated in the local currency (e.g. the Ghana Cedi, the FCFA). The currency of the obligation may become unavailable to the borrower regardless of its particular financial condition.	Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.
Market Risk	Market risk is the risk to a financial institution's condition resulting from adverse movements in market prices or rates, foreign exchange rates, or equity prices.	Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.
Interest Rate Risk	Interest rate risk refers to the exposure of a bank's financial condition to adverse movements in interest rates. This risk impacts on both the earnings of a bank and the economic value of its assets, liabilities and off-balance sheet instruments.	Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.
Operational Risk	Operational risk arises from the potential that inadequate information system, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.	Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.
Liquidity Risk	Liquidity risk is the potential that an institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding at reasonable cost, thereby affecting profitability.	Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day to day basis. Supervisors require banks to have contingency plans for handling liquidity problems.

Sources: The Basle Committee on Banking Supervision (Core Principles for Effective Banking Supervision, October 2006)

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The Committee also made other risk management recommendations aimed at strengthening the entire financial system including its principles on capital adequacy, risk management process, problem asset management, large exposure limits, exposures to related parties, and the existence of effective and adequate internal control and audit. The Committee further identifies four key preconditions, which though outside the direct jurisdiction of supervisors needs to be properly managed because of their impact on the effectiveness of banking supervision. These external elements include sound and sustainable macroeconomic policies, a well developed public infrastructure, effective market discipline, and mechanisms for providing an appropriate level of systemic protection (or public safety net).

2.6 Banking Crises and Failures

Many highly developed economies that have sophisticated markets and long functioning banking systems have witnessed significant bank failures and/or banking crises during the past 30 years[30]. Regulatory and supervisory authorities fear widespread bank failures because they exacerbate cyclical recessions and may trigger a financial crisis; bank failures may cause financial disruptions, erode public confidence in the banking system as a whole and create bank runs. As noted by Noy (2004),[31] the pivotal role played by financial intermediaries implies that any disruption to the smooth functioning of the financial intermediation process is bound to have adverse effects on economic performance and public finances in government's attempts to salvage the crisis. A study by Bachellerie and Couillault (2005)[32] reveals that banking crisis resulted in substantial costs to governments because of efforts to rescue the crisis. The cost to Thailand and Indonesia governments in rescuing their banking crisis was

[30] Basle Committee on Banking Supervision (2004), "Bank Failures in Mature Economies", Working Paper No. 13 (April 2004), http://www.Bis.org/publ/bcbs_wp13.htm.
[31] Ilan Noy (2004), Financial Liberalization, Prudential Supervision, and the onset of Banking Crises, http://www2.hawaii.edu/~noy/papers/banklib.pdf, pp. 341-359 (accessed on March 22, 2006).
[32] Bachellerie A. and Bertrand Couillault (2005), "Public Debt Sustainability and Crises in Emerging Market Countries : A Presentation of the Concepts and Diagnostic Tools", Bank de France Financial Stability Review, No. 6 (June 2005), p.66.

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16% and more than 50% of gross domestic product (GDP) respectively. According to Curry and Shibut (2000), (see Basle Committee on Banking Supervision Working Paper No. 13: April 2004, p.2) the Savings and Loans crisis cost the United States tax payer an amount of US$123.8 billion (2.1% of 1990 GDP).

The causes of banking crisis and failures are varied and depend to the large extent on the stage of a country's development, the effectiveness of regulation and supervision, the effectiveness of market discipline, the extent of transparency and disclosure requirements, the development and application of accounting standards, and the level of government's support's for rule of law. According to Noy (2004)[33], banking crisis and bank failures result from adverse effects of macroeconomic shocks, lending booms and surges in inflows, liberalised financial sector, currency mismatches, government involvement in financial sector, lack of transparency, opaque accounting standards, and legal framework. The most oft-mentioned failure is due to moral hazard in the presence of deposit insurance. Adverse self-selection of loan requests, for example, can pose a serious challenge as it leads banks to sell loans to riskier borrowers, which, in the face of downturn might result in a banking sector collapse.

The lender of last resort promise (to provide liquidity in the face of liquidity shortages) might also introduce inefficiencies and, in addition, pose a practical problem to authorities to differentiate between illiquid and insolvent banks. Hellmann et al. (see Noy 2004: 345) finds that competition can undermine prudent behaviour in the presence of moral hazard and may lead to inefficient (excessive) risk taking by banks. Boyd and De Nicolo (see Noy 2004: 345) present an opposite effect from competition to financial fragility.

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[33] Noy Illan (2004), Financial Liberalisation, Prudential Supervision, and the On-set of Banking Crisis.

A study by the Basle Committee on Banking Supervision (see Working Paper No.13: April 2004) on bank failures and banking crisis of Group of 10 (G10) countries also finds a varied causes of bank failures. Specifically, the paper notes the following factors as some of the main causes of bank failures and banking crisis in the G10 countries:

- financial liberalisation;
- poor regulation and supervision;
- operational weaknesses (including fraud); and
- risk concentration.

Contrary to findings by Noy (2004) on the relationship between the existence of deposit insurance and bank failures and banking crisis, the Basle Committee on Banking Supervision (Working Paper No. 13, April 2004) finds that the presence of deposit insurance helped maintain a high degree of financial stability throughout the USA crisis. Thus, there is little agreement among theorists on the connections between liberalised financial markets and banking sector distress.

2.6.1 Well-Known Bank Failures

In view of the disagreements among theorists about the causes of banking crisis and failures, it is important to present empirical evidence of causes and important lessons to be drawn from some of the well-known bank failures or near failures the world economy had so far witnessed as noted below by the South African Reserve Bank[34], and for which bank regulators and supervisors were criticised and blamed for lax and ineffective supervision in some cases.

[34]South African Reserve Bank, "Current Issues in Banking Supervision", http://www.resbank.co.za/BSUP/ann95/chap2.html

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2.6.1.1 Barings Bank

Barings Bank of Britain collapsed in 1995 as a result of internal control weaknesses and failure. The Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings ("*the Barings Report*") issued to the House of Commons provides valuable insights. An extract from the report headed "*Lessons arising……*" states "*Barings collapse was due to the unauthorised activities of one individual (Leeson) that went undetected as a consequence of a failure of management and other internal controls of the most basic kind. The failings at Barings were not a consequence of the complexity of the business, but were primarily a failure on the part of a number of individuals to do their jobs properly*".

Important issues highlighted by "the Barings Report" include the following:

- All levels of management have a duty to understand fully the businesses they manage.
- Lines of responsibility and accountability have to be clearly established and communicated, and there has to be independent monitoring of internal controls.
- Clear segregation of incompatible duties is essential for any control system to be effective, particularly as regards "front office" and "back office" functions.
- An independent risk-management function has to be established within every financial institution.
- Top management and the audit committee have to ensure that significant weaknesses are resolved quickly and that the internal audit function is accorded sufficient status and unrestricted access to top management.

"The Barings Report" clearly indicates the importance of maintaining a sound system of internal control at every level of banking operations.

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2.6.1.2 Bank for Credit and Commerce International (BCCI)

BCCI, (also in Britain) was closed down in 1991 and about 6,500 depositors, including 28 UK local authorities who had kept funds at the bank losing their money. BCCI was founded by Pakistani banker Agha Hassan Abedi, who began his career running a small Asian bank. BCCI expanded and in 1972, the Luxembourg-based BCCI opened a branch in London. During its operations, BCCI expanded into 69 countries, including Ghana but lost huge sums of money from its lending operations, foreign currency dealings and deposit accounts. BCCI also became a bank of choice for money launderers and terrorists[35]. The failure of BCCI was also due to ineffective internal control systems.

2.6.1.3 Daiwa Bank

In September and October 1995, trading losses of over US$1 billion came to light at both the New York branch and a subsidiary of Japan's Daiwa Bank. Attempts to conceal these losses, due largely to a lack of segregation of duties, and to mislead the USA banking authorities resulted in Daiwa Bank being forced to terminate its banking operations in the USA in February 1996. Mr. Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System at the time, concluded as follows on 27 November, 1995:

> *"I believe that there are valuable lessons to be learned by bankers and supervisors from this unfortunate case. The over US$1 billion loss suffered by Daiwa and Barings illustrate the enormity of the damage that can be incurred by global trading banks when internal control systems are less than adequate. These losses and the institutional injury incurred are far greater than the losses banks have encountered from their authorised proprietary risk-taking positions. Management must pay as much attention to such seemingly mundane tasks as back office settlement and internal*

[35] http://news.bbc.co.uk/go/pr/fr/-/hi/business/4399336.stm, (accessed on March 22, 2006).

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audit functions as to the more exotic high technology front-end trading systems. Banks that neglect making the requisite investments in these areas do so at their peril………… While good examiners are not naïve, and don't expect bankers to bare their souls, normally they must rely on a basic trust that they will not be deceived. However, when a bank has shown through repeated actions that it cannot be trusted, even at the highest levels of cooperation, supervisors should resort to extraordinary regulatory measures."

Supervisory lessons from the Daiwa Bank case are summarised below:

- The non-implementation of basic internal controls can have catastrophic results.
- The financial system is based on integrity, which may not be compromised.
- Even large and imposing banks are not immune from swift and harsh action by bank regulatory and supervisory authorities if their conduct is found to be unacceptable.

2.6.1.4 African Bank

In South Africa, the Banking Supervision Department identified accumulation of large overdues as a serious problem within African Bank and repeatedly brought the matter to the attention of both the management and the board of directors of African Bank. Unfortunately, African Bank was slow to take appropriate action; the warning signals went unheeded to, poor lending practices continued and overdues continued to escalate. In order to prevent a total collapse of the bank, which would have resulted in many small depositors losing all their money, there was no option but to place African Bank under curatorship in September 1995.

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The African Bank case also provides the following important supervisory lessons:

- Bank supervisors should set target dates for the resolution of problem areas within a bank, and that the non-attainment of such targets should result in the entire management team of the particular bank being replaced by the board of directors.
- Neither the bank supervisory authority nor the external auditor can regulate against or prevent problems within a banking institution.
- Decision making should not be centralised within one person.
- While it may be difficult to find persons who are "*fit and proper*" for senior positions, it is possibly even more difficult to ensure that they stay "*fit and proper*".

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From the above-mentioned famous cases of bank failures, losses can be attributed to the absence of adequate functional segregation, combined with insufficient alertness on the part of management and poor internal controls, allowing internal problems to remain undetected for too long a period. Though researchers in the field of economics and banking are yet to come to consensus on the causes of bank failures and banking crisis, especially the 1997/98 East Asian financial crisis, lessons from the above empirical findings provide ample evidence of some of the fundamental causes of the issues that may trigger banking crisis and bank failures.

2.6.2 Dealing with Weak Banks

The old adage of "*prevention is better than cure*" succinctly fits and provides the solution for avoiding banking crisis and bank failures. Bank supervisors will have to face the problem of dealing with weak banks in one stage or the other in their supervisory careers. Though each

case may be different and unique, there are inevitably important common strands, which have been provided by the Basle Committee on Banking Supervision[36] as summarised below:

i) Supervisors should be prepared. In a crisis, time is short and problems have to be faced immediately – often several at once. Delay makes things worse and the solution more costly. It helps considerably if supervisors understand the issues and the options for handling weak banks and also who they can talk to in other organisations and countries.

ii) To deal effectively with weak banks, supervisors need clear objectives and a clear operating framework. The Basel Core Principles for Effective Banking Supervision provide this; and the growing adoption of these standards since 1997 lessens the risk of supervisory action being undermined by legal and accounting gaps and political interference.

iii) Supervisors should use new as well as existing tools to "know" their banks. This is not always easy, given resource and time constraints; but a combination of financial reporting and monitoring, on-site inspection and regular liaison with auditors and bank management already provide a good basis, in many cases, for detecting problems early. If so, these can often be remedied before a bank's solvency is threatened.

iv) Supervisors need to be discriminating. They have to distinguish between the symptoms and the underlying causes of weaknesses, which will influence their choice of corrective action. They have to allow for the "special" factors of state-banks and international conglomerates, but this does not imply forbearance or lenient treatment. They have to be

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[36] Basel Committee on Banking Supervision (March 2002), "Supervisory Guidance on Dealing with Weak Banks" www.Bis.org/publ/bcbs88.htm, p.42 (accessed on March 16, 2006).

proportionate and flexible in their use of tools, judging when a remedial programme is more appropriate than penalties and when (and when not) to publicise restrictions.

v) Banks can and do fail, and there should be public awareness of this. Public bailouts are a last resort. Liquidation is often the right solution, particularly where deposit insurance is well established. Before then, there are a number of now well-tried resolutions and exit techniques which can suit certain circumstances to minimise the disruption to the financial system and resolution costs.

vi) In an increasingly interdependent world, close international co-operation among supervisors in this area is a necessity. Weak bank problems, especially big ones, spill over national boundaries very quickly.

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2.7 Bank Rating Framework

At the end of each on-site examination review, supervisors make an overall assessment of a commercial bank's performance based on their own internally adopted framework. This framework, which provides the supervisory authorities an insight into a bank's composite solvency position, is independent of ratings by the international credit rating agencies. Most supervisory authorities tend to adopt the American uniform rating system, which provides a comprehensive rating result of a banks' performance as indicated below[37]:

i) Capital Adequacy

- Size of the bank.
- Volume of inferior quality assets.
- Bank's growth experience, plans and prospects.
- Quality of capital.
- Retained earnings.
- Access to capital markets.
- Non-ledger assets and sound values not shown on books (real property at nominal values, charge-offs with firm recovery values, tax adjustments).

ii) Asset Quality

- Volume of classifications.
- Special mention loans – ratios and trends.
- Level, trend and comparison of non-accrual and renegotiated loans.
- Volume of concentrations.
- Volume and character of insider transactions.

[37] Sahajwala, R., and Van den Bergh, P., "Supervisory Risk Assessment and Early Warning Systems", Basel Committee on Banking Supervision Working Papers, No. 4 , December 2000, www.bis.org/publ/bcbs_wp4.pdf, pp.45-47 (accessed March 16, 2006).

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iii) **Management Factors**

- Technical competence, leadership etc of middle and senior management.
- Compliance with banking laws and regulations.
- Adequacy and compliance with internal policies.
- Tendencies towards self-dealing.
- Ability to plan and respond to changing circumstances.
- Demonstrated willingness to serve the legitimate credit needs of the community.
- Adequacy of directors.
- Existence and adequacy of qualified staff and programmes.

iv) **Earnings**

- Return on assets compared to peer group averages and bank's own trends.
- Material components and income and expenses – compare to peers and bank's own trends.
- Adequacy of provisions for loan losses.
- Quality of earnings.
- Dividend payout ratio in relation to the adequacy of bank capital.

v) **Liquidity**

- Adequacy of liquidity sources compared to present and future needs.
- Availability of assets readily convertible to cash without undue loss.
- Access to money markets.
- Level of diversification of funding sources (on- and off-balance sheet).
- Degree of reliance on short-term volatile sources of funds.
- Trend and stability of deposits.
- Ability to securitise and sell certain pools of assets.

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- Management competence to identify, measure, monitor and control liquidity position.

vi) Sensitivity to Market Risk

- Sensitivity of the financial institution's net earnings or the economic value of its capital to changes in interest rates under various scenarios and stress environments.
- Volume, composition and volatility of any foreign exchange or other trading positions taken by the financial institution.
- Actual or potential volatility of earnings or capital because of any changes in market valuation of trading portfolios or financial instruments.
- Ability of management to identify, measure, monitor and control interest rate risk as well as price and foreign exchange risk where applicable and material to an institution.

The above rating framework, represents benchmarks for each component, provides guidelines, and presents essential foundations upon which the composite rating is based. They do not eliminate consideration of other pertinent factors by the examiner. This uniform rating system provides the groundwork for necessary supervisory response and helps institutions supervised to be reasonably compared and evaluated.

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The framework captures the composite ratings quantitatively as shown below:

Table 2.2: Composite rating and its interpretation

Rating scale	Rating range	Rating Analysis	Rating Analysis Interpretation
1	1.0-1.4	Strong	Sound in every respect, no supervisory responses required.
2	1.6-2.4	Satisfactory	Fundamentally sound with modest correctable weakness, supervisory response limited
3	2.6-3.4	Fair (watch category)	Combination of weaknesses if not redirected will become severe. Watch category. Requires more than normal supervision.
4	3.6-4.4	Marginal (some risk of failure)	Immoderate weakness unless properly addressed could impair future viability of the bank. Needs close supervision.
5	4.6-5.0	Unsatisfactory (high degree of failure evident)	High risk of failure in the near term. Under constant supervision/cease and desist order.

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2.8 Funding Banking Supervision

The changing phase of commercial banking operations driven by liberalisation, innovation, de-specialisation, and information communication and technology pose a lot of challenge to bank supervisors in that they have to commit resources to understanding, identifying, monitoring, and controlling risk profile of banks. Consequently, bank regulatory and supervisory authorities are faced with budgetary constraints if they are to stay on top of the supervisory process. The opposite action of adopting a lax approach to supervising commercial banks as a result of budgetary constraints can be as disastrous as anything. The question then is how can bank supervisors stay ahead of the ever changing, complex, and growing commercial banking industry, especially in developing countries where bank supervisors face resource and budget constraints[38]?. As a result of budgetary constraints, supervisory units are often understaffed and this affects supervisor's ability to conduct bank

[38] Polizatto, Vincent P. "Building an Effective Framework for Bank Supervision", http://www1.worldbank.org/finance/PUBS/POLIZATT/poli001d.htm, pp.1-8 (accessed on March 13, 2006)

supervision very well. Polizatto asserts that the most capable and qualified individuals are frequently employed in the private sector. This affects supervisory authorities' ability to attract and retain qualified staff.

Needless to say that adequate staffing for bank supervisory authority, both in terms of quantity and skill levels is a must. To attract and retain qualified staff, compensation should be competitive within government. Governments frequently argue that they cannot afford additional staff or higher salaries nor can they justify differentiated salaries within government. Polizatto argues that government cannot afford a banking crisis and its debilitating effects on economic growth and development. The cost of even one bank failure may far exceed the costs incurred in employing and retaining competent staff, a situation clearly demonstrated by the United States of America savings and loans crisis when requests for additional staff were denied by the government administration then in power.

A study by Masciandaro et al (2006)[39] on financing banking supervision reveals that the financing rule is a function of two main factors – type of supervisory authority and the structure of the financial system. The study asserts that if the supervisor is a central bank the public funding is more likely to occur but if the supervisor is a financial authority a levy on the regulated banks is more likely to occur (i.e. the cost is borne by both the state and the regulated banks in an agreed manner). From the foregoing two key models, comes a third model, where the cost of the on-site supervision is borne by the regulated banks.

[39] Masciandaro, Donato; Nieto, Maria J. and Prast, Henriette, "Who pays for Banking Supervsion? Principles, Practices, and Determinants" (April 2006). University of Bocconi Monetary and Financial Economics Working Paper No. 169 Available at SSRN: http://ssrn.com/abstract=918166.

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2.9 Deposit Insurance Institution

The bedrock of effective and efficient financial intermediation is public confidence. Though there is no complete consensus yet among practitioners about the relevance of deposit insurance scheme, evidence has shown that the benefits of deposit insurance institution outweigh the demerits, in maintaining public confidence in banking industry thereby achieving stability in banking and financial markets. Cull et al (2004)[40] asserts that the key problem with deposit insurance institutions is the incentive for these institutions to engage in moral hazard thereby taking on excessively high-risk activities relative to socially optimal outcomes. They however concluded that deposit insurance institutions lead to long-term growth in financial intermediation only in countries where the rule of law is well established and bank supervisors are granted sufficient discretion and independence from legal reprisals.

According to Greenspan (2002)[41], deposit insurance was adopted in the United States of America as part of the legislative framework for limiting the impact of the Great Depression on the public and mainly to protect the unsophisticated depositors with limited financial assets from the loss of their modest savings. Fullani (2006)[42] agrees with Greenspan that deposit insurance has played a key - and at times even critical - role in achieving stability in banking and financial markets.

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[40] Cull, Robert ; Senbet, Lemma ; and Marco Sorge (2004), "Deposit Insurance and Bank Intermediation in the Long Run", BIS Working Papers No 156, June 2004, http://www.org/dcms/dfs.jsp?.sp, (accessed on September 21, 2006).

[41] Greenspan, Alan (April 23, 2002), "Federal deposit insurance reform", http://www.bis.org/review/r020423a.pdf, (accessed on September 21, 2006), pp.1-6.

[42] Fullani, Ardian (May 30, 2006), "Financial policy issues of deposit insurance schemes in South-East Europe", http://www.org/dcms/dfs.jsp?.sp, (accessed on September 21, 2006).

2.10 Credit Risk Management

Arguably, credit risk remains one of the greatest risks facing banks and other non-bank financial institutions that advance credit to the public. As a result, banks as well as bank supervisors commit a lot of resources through developing very robust and reliable credit models aimed at identifying, measuring, controlling, and managing credit risk. Both theory and empirical evidence show that a key element in managing credit risk in developed countries and emerging economies is the existence and use of public credit registers, which is regarded as the main tool for aligning regulatory capital with the underlying risks in banks' loan portfolios to effectively address relevant recommendations of Basel II[43].

According to Artigas (2004), the existence and use of credit registers enable bank supervisors to monitor credit risk in the entire economy, permit each individual bank to accurately assess the quality of its credit assets and actually measure the concentration of its risk exposures (sectorally, geographically, single obligor, etc). Credit registers assist impose discipline on borrowers as they help limit over-indebtedness and contribute to increasing debt service efforts as well as providing a better and more exact knowledge of every borrower's credit quality and creditworthiness. Artigas (2004) holds the view that credit registers favourably assist minimise adverse selection and moral hazard issues, foster transparency, lower interest rates, and contribute to raising the stability of the entire financial system. The author believes that though the building of credit registers come with challenges in terms of resource commitment, informational content and credibility, its usefulness cannot be over-emphasised as is helps in building a bad debt register as well. Both the credit registers and a bad debt register are very useful in supporting formulation of sound macro economic and monetary policies.

[43] Artigas, T. Carlos (September 2004), "A review of credit registers and their use for Basel II", http//www.bis.org/dcms/dfs.jsp?sp-q=credit+register (accessed on April 12, 2007).

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CHAPTER 3

BANKING INDUSTRY IN GHANA

3.1 Introduction

The banking system in Ghana has developed systematically over the years. It is currently (at June 2006) made up of twenty-three (23) banks, engaged in various commercial, development, merchant, and universal banking activities (Table 3.1). In addition[44], there are currently (at June 2006) one hundred and twenty-one (121) community/rural banks. With technical assistance from the World Bank, the government established the ARB Apex Bank Limited to assist the Bank of Ghana in monitoring the operational activities of the community/rural banks and also providing them with day-to-day technical assistance. Bank of Ghana has statutory responsibility for ensuring a healthy and sound banking system in the country. The roles and activities of these banks in the country are complemented by non-bank financial institutions, which operate in the areas of hire purchasing, finance leasing, stock brokerage, general financing, and funds management. Ghana Stock Exchange provides a platform for dealings in the equities and bonds of listed companies.

3.2 Historical Development of Banking Industry in Ghana

The evolution of banking in Ghana (formerly the Gold Coast) dates back to the late 19th century. Before Ghana's independence in 1957, the business of commercial banking services in Ghana was provided by two British-owned banks, namely Bank of British West Africa and Barclays D.C.O. Until 1953, the West African Currency Board was responsible for the central banking functions in Ghana[45]. The International Monetary Fund (IMF) report notes that the first bank to be established in Ghana was the Bank of British West Africa (now the Standard

[44] Banking Supervision Department of the Bank of Ghana.
[45] International Monetary Fund Report - Ghana: Selected Issues, November 18, 1998, pp.17-29.

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Chartered Bank Ghana Limited) in 1896. This was followed by the establishment of Barclays Bank D.C.O (now Barclays Bank of Ghana Limited) in 1917.

Table 3.1: List of banks by type and year of establishment as at June 2006

Name of Bank	*Type*	*Date Established*
1). Standard Chartered Bank (Ghana) Limited	CB	1896
2). Barclays Bank of Ghana Limited	UB	1917
3). Ghana Commercial Bank Limited	CB	1953
4). National Investment Bank	DB	1964
5). Agricultural Development Bank	DB	1965
6). Merchant Bank (Ghana) Limited	UB	1972
7). SG-SSB Limited (formerly SSB Bank Limited)	CB	1977
8). Ecobank (Ghana) Limited	UB	1990
9). CAL Merchant Bank Limited	UB	1990
10). The Trust Bank (Ghana) Limited	CB	1995
11). Prudential Bank Limited	DB	1994
12). First Atlantic Merchant Bank Limited	MB	1995
13). Metropolitan and Allied Bank Ghana Limited	CB	1995
14). International Commercial Bank Limited	CB	1996
15). Amalgamated Bank Limited	MB	1999
16). Stanbic Bank (Ghana) Limited	UB	1999
17). Unibank Ghana Limited	CB	2000
18). ARB Apex Bank Limited	AB	2001
19). HFC Bank Ghana Limited	UB	2003
20). Standard Trust Bank Ghana Limited	UB	2004
21). Zenith Bank (Ghana) Limited	UB	2005
22). Guaranty Trust Bank Ghana Limited	UB	2006
23). Fidelity Bank Limited	UB	2006

CB = Commercial Bank. DB = Development Bank. MB = Merchant Bank. UB = Universal Bank, AB = Apex Bank
Source: IMF Report 1998 and Bank of Ghana (Banking Supervision Dept.)

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The IMF report further notes that these expatriate banks, which were established to finance and facilitate foreign trade between Ghana (then the Gold Coast) and Britain, handled the commercial banking business in the country until 1953. These two banks handled purely banking needs of the expatriates and foreign business firms.

In 1951 however, when Osagyefo Dr. Kwame Nkrumah became the leader of government business in the Gold Coast, he felt the need for establishing a "*national bank*". According to Asamoah (1997)[46] in the same year (1951), Sir Cecil Trevor, a former Deputy Governor of the Reserve Bank of India, was invited to the Gold Coast to conduct an investigation into the need for, and the requirements of establishing a national bank. In October 1952, the then Legislative Assembly of the Gold Coast passed the Bank of Gold Coast Ordinance No. 49 of 1952. The passing of the Bank of Gold Coast Ordinance led to the establishment of the first indigenous commercial bank, the Bank of the Gold Coast (now Ghana Commercial Bank Limited) in 1953 to provide banking services to the local populace and also to serve as the Central Bank to the country.

With Ghana's attainment of independence in 1957, the Bank of Ghana was established as a central bank for the country and also to take over the central banking functions that had previously been undertaken by the West African Currency Board and the Bank of the Gold Coast. After independence and with the growth in the economy, the government realised the need for the establishment of development banks to finance and assist enterprises in all sectors of the economy, especially agro-industry, large scale farming projects, and mortgage lending, which were left out by the three existing commercial banks. This led to the establishment of

[46] Asamoah, I.K. (1997), "The Policy Objectives and Implementation of the Financial Sector Adjustment Programme: The Experience of Ghana Commercial Bank Limited (GCB) (1991-1995)". A Published Thesis in Master of Public Administration presented to the School of Administration, University of Ghana, Legon, June 1997, pp.61-72.

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National Investment Bank, Agricultural Development Bank, and Bank for Housing and Construction (now in liquidation). In 1970, the first indigenous Banking Act, 1970, (Act 339) was enacted to provide a legal framework for commercial banking business in the country. Asamoah notes that until early 1990, the commercial banking industry in Ghana was state dominated, regulated, and controlled. Private sector ownership and participation was on the low side because the legal framework did not provide adequate protection to investors and depositors. The weaknesses of the Banking Act, 1970 (Act 339) was very much felt in the early 1980s and was subsequently replaced with a more focused Banking Law in 1989, Provisional National Defence Council Law (PNDCL) 225. The promulgation of the PNDCL 225 however created some level of confidence in the private sector and saw an increase in the number of commercial banks in Ghana after 1980s (see Table 3.1). After a decade and half of its existence, the PNDCL 225 was replaced with the Banking Act, 2004 (Act 673). The main rationale behind the enactment of the new Banking Act, 2004 (Act 673) was because the monetary authorities felt the need for the law to be abreast with dynamism in the banking industry and also to be more focused, explicit, and to correct weaknesses that were identified with the operationalisation of the PNDCL 225 of 1989.

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3.3 Structure of Banking Industry in Ghana

Ghana's banking industry can be structured into six (6) categories as shown in Table 3.2 below:

Table 3.2: Structure of banking industry in Ghana as at June 2006

	Category	Nature of Activity
1	Bank of Ghana	Monetary policy, including regulation and supervision of banks
2	Commercial banks	Required to focus on the **retail** end of the market
3	Development banks	Required to focus on customers in the **developmental** end of the market
4	Merchant banks	Required to focus on the **wholesale** end of the market
5	Universal banks	Expected to provide banking services to **every segment** of the market in the country.
6	Rural/Community banks	Expected to serve the banking needs of **rural populace** within their respective catchments.

These six categories are based principally on regulation under which a bank was established and the nature and type of permissible banking business banks are required to undertake in the country. The category of a bank is determined at the point of licensing by the Bank of Ghana and therefore is underpinned by specific regulation. In practice, however, it is difficult to draw a clear line between the operational activities of commercial banks, development banks, merchant banks, and universal banks; they provide basically same services.

In terms of ownership structure, there were thirteen (13) locally-owned banks and ten (10) foreign-owned banks in operational existence in Ghana as of June 2006. A local bank refers to a bank in which more than 50% of its issued shares are held by Ghanaians while a foreign bank refers to a bank in which more than 50% of its issued shares are held by non-Ghanaians. Though the local banks dominate the banking industry in Ghana in terms of sheer numbers,

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the depth of financial intermediation is dominated by the foreign banks, which have relatively stronger capital base[47].

3.4 Banking Sector Reforms in Ghana

The banking sector in Ghana had undergone structural reforms in the late 1980s to early 1990s. The IMF report (1998) notes that after years of state ownership, regulation, and management, the banking sector in Ghana became distressed. Banks suffered from undue political interference, poor management, inadequate capital, and poor accounting systems and weak internal controls. The banks failed to apply uniform accounting standards based on accepted accounting principles. They had no legal obligations to build up loan-loss reserves. As a result, they had large portfolios of non-performing loans, insufficient provisions for bad debts and were often over-exposed to a few customers, especially state-owned enterprises. The banking industry was close to a crisis at the end of 1989 with its non-performing loans, reaching 41% of total credit portfolio. Nevertheless, Sheng and Tannor (1996)[48] note that no sudden liquidity crisis and bank runs occurred because the banking system was mostly state-owned and its investments were predominantly in the public sector.

In the face of these unfavourable situations, the government commissioned a diagnostic study in 1987 to identify weaknesses in the banking industry and to formulate appropriate policies to address the shortcomings. The findings of the diagnostic study assisted the government to adopt a reform program called the Financial Sector Adjustment Programme in 1988 with the objective of reviewing the legal and regulatory framework and amending the existing Banking Act, 1970 (Act 339), restructuring the banking sector to make the banks viable and efficient,

[47] Source : Banking Supervision Department of the Bank of Ghana.

[48] Sheng, A. and A.Tannor (1996), "Ghana's Financial Restructuring, 1983-91", Bank Restructuring: Lessons from the 1980s, 1996, World Bank, Washington, D.C., p.123-132.

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as well as revitalising the financial sector by creating new institutions[49]. These reforms led to the promulgation of Banking Law, 1989 (PNDCL 225), the establishment of the National Banking College to provide professional training to personnel of banks, development of accounting manual for banks, the strengthening of the Banking Supervision Department, and establishment of new banks and financial institutions.

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[49] Sowa, N.K., and I.K. Acquaye (1999), "Financial and Foreign Exchange Markets Liberalisation in Ghana", Journal of International Development, 1999, Vol. 11, pp.385 - 409.

3.5 Legal and Regulatory Framework

The legal environment of banking in Ghana is regulated by various laws, which provide a framework for the entire financial intermediation process. Currently, the laws affecting the establishment, operation, regulation, and supervision of banks in Ghana are derived from constitutional, statutory, judicial, and customary sources[50] as shown in Table 3.3 below:

Table 3.3: Central and commercial banking statutes in Ghana

Central Banking Statutes

1. Exchange Control Act, 1961, (Act 71)
2. Currency Act, 1964 (Act 242)
3. National Mortgage, Financing and Guarantee Scheme, 1976, (S.M.C.D. 23)
4. Banking Act, 2004 (Act 673)
5. The 1992 Constitution of Ghana, Article 183 & 184
6. Bank of Ghana Act, 2002 (Act 612)
7. Financial Institutions (Non-Banking) Law, 1993 (P.N.D.C. Law 328)
8. Securities Industry Law, 1993 (P.N.D.C. Law 333)

Commercial, Development, Merchant and Universal Banking Statutes

1. Bills of Exchange Act, 1961 (Act 55)
2. Exchange Control Act 1961 (Act 71) and its Regulations (L.I. 133 of 1961)
3. Companies Code, 1963 (Act 179)
4. Bodies Corporate (Official Liquidation) Act, 1963 (Act 180)
5. Agricultural Development Bank Act, 1965 (Act 86) as amended by NLCD 182 of 1967 and Act 352 of 1970.
6. Banking Act, 2004 (Act 673)
7. Non-Performing Assets (Loans, Investments) Recovery Act, 1996 (518)
8. Company Regulations of each bank
9. Regulations made by the Minister of Finance
10. Notices, Directives, and Orders made or issued by the Bank of Ghana

Source: Addeah, K., Banking and Financial Law Journal of Ghana, November 1998, Vol. 1, No. 1, p. 4 – 15 (modified)

[50] Addeah, K. (1998), "The sources of Banking and Financial Law in Ghana", Banking and Financial Law Journal of Ghana, November 1998, Vol. 1, No 1, pp.4-15.

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However, the main and the current law that provides the regulatory framework for establishment, operation, regulation, and liquidation of banks in Ghana is the Banking Act, 2004 (Act 673). The main provisions codified in the Banking Act, 2004 (Act 673) are:

3.5.1 Licensing Procedures and Permissible Activities

Sections 3 to 22 of the Banking Act, 2004 (Act 673) detailed out procedures for applying for, obtaining, or refusal of a banking licence in Ghana. Section 11 specifically provides permissible activities of banks in Ghana as "*A bank shall not carry on any business other than any of the following:*

a) acceptance of deposits and other repayable funds from the public;
b) lending;
c) financial leasing;
d) investment in financial securities;
e) money transmission services;
f) issuing and administering means of payment including credit cards, travelers cheques and bankers' drafts;
g) guarantees and commitments;
h) trading for own account or for account of customers in,
    i) money market instruments,
    ii) foreign exchange, or
    iii) transferable securities;
i) participation in securities issues and provision of services related to those issues;
    a) advice to undertakings on capital structure, acquisition and merger of undertaking;
    b) portfolio management and advice;
    c) the keeping and administration of securities;
    d) credit reference services;
    e) safe custody of valuables;
    f) electronic banking; and
    g) any other services as the Bank of Ghana may determine.

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The same Section confers on the Bank of Ghana discretionary power to restrict or remove any permissible activities it considers appropriate. It can be noted that the law deals with the exclusivity of banking activities aimed at avoiding ambiguity in operation of banking business in Ghana and any consequential legalities arising thereof.

3.5.2 Capital and Reserves

Maintenance of capital adequacy is a means through which bank management is made to lend out money in judicious manner while safeguarding the interest of depositors and creditors. Section 23 (1, 2, and 3) of Banking Act, 2004 (Act 673) states that "*A bank shall at all times while in operation maintain a minimum capital adequacy ratio of ten per cent. The bank of Ghana may by directive prescribe a higher capital adequacy ratio with respect to a particular bank or all banks for the period that the Bank may prescribe. The capital adequacy ratio may be measured as a percentage of the adjusted capital base of the bank to its adjusted asset base in accordance with Regulations made by the Bank of Ghana*". The Section 24 also confers discretionary powers on the Bank of Ghana to require a bank to maintain additional capital backing where a bank is considered to have specific concentration risk.

3.5.3 Risk Exposures

Sheng (1996)[51] notes that banking is generally a service of intermediation. Banks fail because of human errors or faults, whether fraud, mismanagement, poor policies, or inadequate supervision. In the process of intermediation, banks come across array of risks such as credit risk, market risk, settlement risk, operational risk, liquidity risk, and legal risk. Since these risks would have to be identified, monitored, and controlled, the Banking Act, 2004 (Act 673) provides a framework within which some of these risks could be managed.

[51] Sheng, A. (1996), "Resolution and Reform: Supervisory Remedies for Problem Banks", Bank Restructuring: Lessons from the 1980s, 1996, The World Bank, Washington, D.C. p.49.

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Part VI of the Banking Act, 2004 (Act 673) restricts banks on the nature and extent of lending and investment activities to undertake. While Section 41 of the Banking Act, 2004 (Act 673) prohibits banks from granting advances against security of own shares, Section 42 limits a bank's single obligor or group financial exposure not to exceed 25% of bank's net own funds for secured advance, credit, financial guarantee or indemnity. For unsecured financial exposure (advance, credit, financial guarantee or indemnity), the Act prescribes 10% of the bank's net own funds. Section 43, which deals with financial exposure to all related parties, requires Bank of Ghana's prior approval for unsecured financial exposures. This same Section restricts secured financial exposure to related parties to 10% of bank's net own funds.

In terms of establishment of a subsidiary company, a bank requires Bank of Ghana's prior approval (Section 46 of the Banking Act, 2004). Section 47 further limits a bank's equity investments in a subsidiary to 15% of bank's net own funds but 25% where the equity investments are in more than one subsidiary. The same section restricts aggregate investment of any financial exposure including credit facilities (loans, advances, guarantees, etc) in any one subsidiary to 25% of the bank's net own funds but 35% with respect to more than one subsidiary. A bank's investments in the share capital of a body corporate or an institution other than its subsidiaries is restricted to 10% of its net own funds. These risk exposure provisions enshrined in the Banking Act, 2004 (Act 673) are meant to control the extent to which banks concentrate resources and thereby expose themselves to risk while at the same time protecting the interest of depositors and creditors.

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3.5.4 Performance Reporting and Monitoring

The Banking Act, 2004 (Act 673) requires banks to submit various periodic (daily, weekly, monthly, etc) prudential returns and reports to the Banking Supervision Department of the Bank of Ghana. These returns and reports include statements of assets and liabilities, statements of loans, advances, and overdrafts, statements of reserve assets, projected capital expenditures, and return on board of directors' backgrounds. The objective of submitting these prudential returns and reports by the banks is to enable the regulatory and supervisory authorities to monitor the performance of banks on a continuous basis in order to take any preventive action where necessary rather than wait to take curative measures.

3.5.5 Penalties (non-compliance) and Powers

Almost every Section of the Banking Act, 2004 (Act 673) prescribes penalties to be imposed on banks for violation or non-compliance with the provisions of the Banking Act, 2004 (Act 673). The penalties include financial fines and custodial sentences. These penalties are meant to deter banks from non-compliance and also to ensure that they carry out their activities in the interest of their stakeholders, especially depositors and the general public. Section 28 of the Banking Act, 2004 (Act 673) confers on the Bank of Ghana special and various policy options, powers, and actions it can take (e.g. facilitate merger of a weak bank with a healthy bank, wind up, etc) when it is satisfied that a bank is not conducting its business in the interest of its depositors and creditors. Some of the special powers of the Bank of Ghana enshrined in the Act include assumption of control of banking business, revocation of banking licence, prohibition of receipt of fresh deposits, prohibition of granting of credits. The Act also provides room for remedial procedures in case any bank is dissatisfied with any action taken by the regulatory and supervisory authorities.

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3.5.6 Independence of the Bank of Ghana

The independence of the Bank of Ghana and for that matter the activities of its Banking Supervision Department is enshrined in Section 3 (2) and 4 (d) of the Bank of Ghana Act, 2002 (Act 612), which provides that "*The Bank of Ghana to independently promote the effective and efficient operation of the banking and credit systems in Ghana. The functions of the Bank to include regulation, supervision and direction of the banking and credit systems to ensure smooth operation of the financial sector*".

However, section 9 of the Banking Act, 2004 (Act 673) provides room for an aggrieved party, whose application for a banking licence is refused to seek redress from the Minister of Finance. Section 9 (3, 4, 5, and 6) states "*a person whose application is refused, may petition the Minister in writing; the Minister shall refer the matter to a panel; the panel shall consist of three experts, one chosen by the Bank and two by the Minister; the panel shall prepare a report which shall be submitted to the Minister for his decision*".

The study finds that the above two legal provisions conflict each other operationally and concludes that the independence of the Bank of Ghana is therefore compromised by Section 9 (3, 4, 5, and 6) of the Banking Act, 2004 (Act 673). The objective of the Banking Act, 2004 (Act 673) to correct the weaknesses of the old Banking Law, 1989 (PNDCL 225) and to provide a robust regulatory framework for banking business in Ghana could therefore be undermined by this defect.

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3.6 Supervisory Framework

The relationship of the Bank of Ghana as the Central Bank with the other banks in the country is governed by the provisions of the Bank of Ghana Act, 2002 (Act 612) and Banking Act, 2004 (Act 673). The supervisory powers of the Bank of Ghana is provided in Sections 3 (2) and 4 (d) of the Bank of Ghana Act, 2002 (Act 612) as follows: *"The Bank of Ghana to independently promote the effective and efficient operation of the banking and credit systems in Ghana. The functions of the Bank to include regulation, supervision and direction of the banking and credit systems to ensure smooth operation of the financial sector".*

Section 2 (1) of the Banking Act, 2004 (Act 673) re-echoes the regulatory and supervisory functions of the Bank of Ghana, inter alia, *The Bank of Ghana shall have an overall supervisory and regulatory authority in all matters relating to banking business and shall be responsible for:*

- *(a) promoting an effective banking system;*
- *(b) dealing with any unlawful or improper practices of banks, and*
- *(c) considering and proposing reforms of the laws relating to banking business.*

Apea (2000) asserts[52] that supervision of banks in Ghana is to ensure that banks operate within a regulatory framework designed to facilitate achievement of monetary policy targets. This function requires banks to be closely monitored, especially where they are obliged to maintain prescribed quantitative targets. The Banking Supervision Department of the Bank of Ghana carries out supervision of banks in Ghana in order to ensure that banks operate within the provisions of both the legal framework and the prescribed prudential guidelines.

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[52] Apea, S.K. (2000),"The Repercussions of the Liquidation of the Bank for Housing and Construction and the Cooperative Bank Limited" Governance, Vol. 2000 No.03 ISSN 0855-2452, A Publication of the Institute of Economic Affairs, February 2000, p.12.

3.7 Conclusion

Clearly, the Banking Act, 2004 (Act 673) adequately provides what could be described as the "*cradle to the grave*" approach to undertaking banking business in Ghana. It lays the fundamental foundation for the entire banking industry by providing the essential requirements, the "*dos and don'ts*", enforcement procedures, as well as protective, operational, and liquidation powers and procedures. The Banking Act, 2004 (Act 673) caters proactively for all the twenty-five (25) principles espoused by the Basel Committee on Banking Supervision in its recent publication[53].

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[53] Core Principles for Effective Banking Supervision, October 2006.

CHAPTER 4

RESEARCH METHODOLOGY

4.1 Introduction

This chapter deals with the research method that was employed to collect and analyse data so as to achieve the research objectives stated in chapter one. The study is a pure descriptive project work, which seeks to measure and estimate the frequency with which things occur, and the degree to which correlation exists between variables.

4.2 Instrumentation

The instruments that were designed for collection of data, which served as the basis for the qualitative analyses and part of the quantitative analyses, were the questionnaire and unstructured interviews. A questionnaire was designed and administered by post to the Head of the Banking Supervision in Ghana. Initially, telephone calls were used, and followed up by personal visits to expedite responses. For primary data collection, both open ended and closed questions were used to widen the scope of data capture. Secondary data in the form of audited accounts and other relevant data of banking industry were also solicited and used for the study.

The questionnaire was administered with the understanding that there would be follow-up unstructured interviews to clarify issues considered key to the questionnaire as well as collection of additional data considered relevant and supplementary to the responses to the questionnaire. Some unstructured interview sessions and discussions were later held with the Deputy Head of the Banking Supervision Department, who coordinated the responses to the questionnaire.

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4.3 Method of Data Analyses

Data were analysed using descriptive statistics. Responses duly received were coded and transcribed into computer for analysis. Trends observed were used as basis for interpretation of the findings, recommendations, and conclusion. Qualitative data analyses made use of assessments and evaluation of the responses to the questionnaire and other supplementary data that were collected.

Ratio analyses were also used in the study. Barnes (1987)[54] notes that financial ratios are used in statistical models for mainly predictive purposes, such as corporate failures and risk assessments, Kieso and Weygandt (1992)[55] support this view by asserting that analyses of financial ratios help identify an organisation's present strengths and weaknesses.

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[54] Barnes, P. (1987), "The Analysis and Use of Financial Ratios: A Review Article", Journal of Business Finance & Accounting, (Winter 1987), Vol. 14, No. 4, pp. 449-461.

[55] Kieso, D.E. and J. J. Weygandt (1992), Intermediate Accounting, 1992, 7th Edition, Von Hoffman Press, Inc. pp.1342, 1356.

CHAPTER FIVE

5.0 DATA ANALYSIS AND INTERPRETATION

5.1 Introduction

This chapter deals with analysis and interpretation of the results of the study. Data collected were categorised into two - qualitative and quantitative - to facilitate meaningful analysis, evaluation, and interpretation. Data presentations were done using tables and graphs.

5.2 Objectives of Banking Supervision in Ghana

The Banking Supervision Department (BSD) of the Bank of Ghana was set up in 1963 to carry out supervision of banks in Ghana in order to ensure that banks are operating within the provisions of both the legal framework and prescribed prudential guidelines. Currently, BSD's functional objectives include:

- Ensuring safe and sound financial institutions;
- Ensuring stable financial system;
- Consumer Protection;
- Ensuring fair competition; and
- Facilitating effective and efficient payment system

As of June 2006, BSD's regulatory and supervisory activities covered a total of 176 licensed banks and financial institutions (e.g. commercial banks, rural/community banks, finance houses, discount houses, savings and loans companies, leasing companies) operating in Ghana. BSD's operational activities are guided by a five (5) year strategic plan, spanning the years 2005 – 2009.

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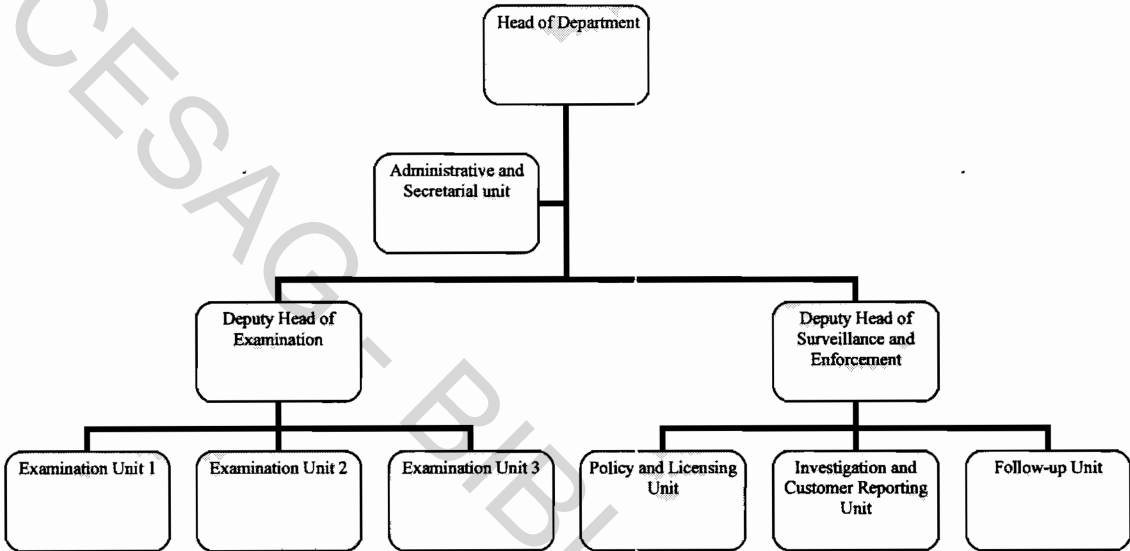
5.3 Organogram of Banking Supervision Department of the Bank of Ghana

The organisational chart of the Banking Supervision Department of the Bank of Ghana is flattened in Figure 5.1 below:

Figure 5.1: Organogram of Banking Supervision Department of the Bank of Ghana



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5.4 Functional Units of Banking Supervision Department of the Bank of Ghana

In order to effectively and efficiently discharge its objectives (see 5.2), the BSD is divided into six (6) functional Units, with each Unit assigned specific responsibilities as follows:

5.4.1 Off-site Supervision Unit

This Unit is charged with:

- Review and analysis of prudential returns;
- Preparation of periodic reports (e.g. Quarterly review reports);
- Compile annual trends and progress in banking in Ghana; and
- Compile BSD annual reports.

5.4.2 On-Site Examination Unit

This Unit is responsible for:

- Visiting banks and examining their records, systems, governance, and financial health; and
- Rating banks according to an-house model.

5.4.3 Follow-up Unit

Follow-up Unit is charged with:

- Ensuring that banks respond to concerns raised by other units;
- Reviewing external audit reports; and
- Reviewing internal audit reports.

An examination Unit is responsible for both on-site and off-site surveillance/examination of banks assigned to it and therefore the three Units above (i.e. Off-site Supervision Unit, On-Site Examination Unit, Follow-up Unit) adopt an integrated or portfolio approach to supervision.

5.4.4 Investigation and Customer Reporting Unit

This Unit is responsible for:

- Investigating and responding to customer complaints;
- Ensuring that bank customers' rights are protected;
- Investigating fraud and other malpractices; and
- Keeping dossier of dismissed staff of banks.

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5.4.5 Policy and Licensing Unit

The responsibilities of this Unit include:

- Reviewing applications for licensing of banks and non-banks, including their branches/agencies;
- Reviewing products and services;
- Premises inspection;
- Reviewing closure of branches;
- Reviewing relocation of branches; and
- Carrying out due diligence on promoters, directors, and key management staff.

5.4.6 Administrative and Secretarial Unit

The Administrative and secretarial Unit is responsible for:

- Keeping staff records;
- Processing imprest for trekking; and
- Managing vehicle movements.

5.5 Monitoring of Banks

BSD monitors the operations of banks in Ghana using among others the BSD Prudential Returns. Currently, banks operating in Ghana are required to submit periodically twenty-five prescribed returns to the Banking Supervision Department for monitoring purposes and in compliance with the regulatory requirements.

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The type, name, frequency and time limit for submission of these prudential returns covering various aspects of the operations of each bank in Ghana is itemised in Table 5.1 below:

Table 5.1: List of prudential returns

Type	Name of Return	Frequency of Submission	Time Limit For Submission
BSD1	Liquidity Reserve Returns	Weekly	9 days
BSD1A	Twenty largest withdrawals over the counter	Weekly	9 days
BSD1B	Daily Net Open Position	Weekly	9 days
BSD2	Statement of Assets and Liabilities	Monthly	14 days
BSD2A	Report on Foreign Currency Exposures	Monthly	14 days
BSD3A	Large Exposures – Advances and Deposits	Monthly	14 days
BSD3B	Large Exposures – Advances and Deposits of subsidiaries	Monthly	14 days
BSD4	Sectoral analysis of Overdrafts, Loans and other Advances	Monthly	14 days
BSD5	Capital Adequacy Return	Monthly	14 days
BSD5B	Consolidated Capital Adequacy Return	Quarterly	14 days
BSD6A	Maturity Analysis of Assets and Liabilities in Cedis	Monthly	14 days
BSD6B	Maturity Analysis of Assets and Liabilities in Foreign Currency	Monthly	14 days
BSD7A	Current Year Results	Monthly	14 days
BSD7B	Current Year Consolidated Results	Quarterly	14 days
BSD8	Advances Subject to Adverse Classification	Monthly	14 days
BSD9	Consolidated Balance Sheet	Quarterly	14 days
BSD10	Capital Expenditure	Half-Yearly	14 days
BSD11	Statutory Return	Half-Yearly	14 days
BSD12	Opening, Closure or Re-location of Bank Branches and Agencies	As Necessary	Not applicable
BSD13	Net Open Position	Monthly	14 days
BSD14	Interest Rate	Weekly	9 days
BSD15A	Charge – Domestic	Weekly	9 days
BSD15B	Charge – Foreign	Weekly	9 days
BSD16	Automated Teller Machine Operations	Monthly	14 days
BSD17	Foreign Inward Remittances	Monthly	14 days

Source: Banking Supervision Department of the Bank of Ghana

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These returns are generic in design because they were designed for the whole banking industry and do not capture peculiar operational characteristics of say foreign banks from local banks, or commercial, development, merchant, and universal banks. These prudential returns, which are mostly quantitative in nature, are to ensure that banks operate within a regulatory and supervisory framework designed to facilitate the achievement of monetary policy targets. The prudential returns serve as a conduit for early warning signals, a basis for monetary policy/directive formulation, and also enable BSD to monitor timing of submission, determine accuracy and reliability of the returns submitted through the use of statistical analysis. The prudential returns are revised periodically in line with changes in the regulatory framework and other Bank of Ghana Notices and Directives aimed at strengthening and facilitating the supervisory process.

Prescribed financial ratios are computed for each bank and compared with past performance of each bank, peer group and the banking industry. Any adverse observations and infractions of the Banking Act, 2004 (Act 673) are communicated to management of the bank concerned for corrective action. For the years 2004 and 2005, the banking industry's compliance rate in respect of timeliness, completeness, and accuracy of submission of the prudential returns averaged 97.5%. The 2.5% deviation might have been due to human failures/errors, technological imperfections among others.

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5.6 Liquidity Position

The Banking Act, 2004 (Act 673) requires each bank carrying on business of banking in Ghana to maintain a certain percentage of customers' deposits in liquid assets (such as cash and Government treasury bills/bonds). The liquid assets positions of the banking industry in Ghana for the years 2001 to 2005 is shown in Table 5.2 below:

Table 5.2: Liquid asset positions of the banking industry

Year	Statutory (in %)	Actual (in %)
2005	24	55.20
2004	44	68.83
2003	44	65.94
2002	44	55.64
2001	44	60.35

The above actual liquidity ratios vis-à-vis their respective statutory requirements clearly indicated that the banking industry in Ghana was very liquid during the years 2001 to 2005. However, the otherwise higher actual ratio of 55.20% compared to the statutory requirement of 24% in the year 2005 could be due to the industry's aversion to risk (preferred risk-free liquid assets as opposed to credit/loans) or relatively higher discount rate earned on the liquid assets.

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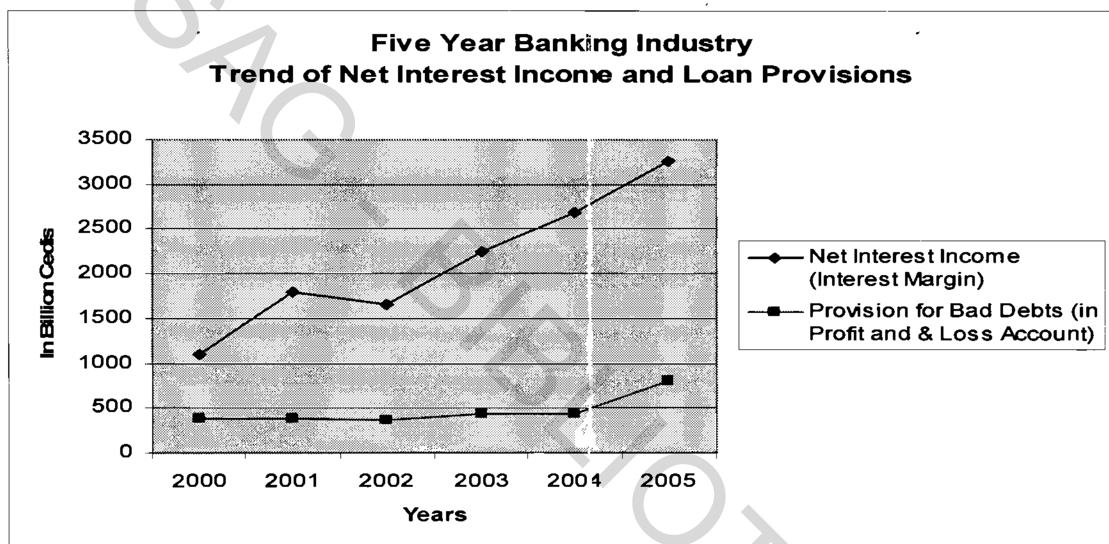
5.7 Solvency Position

As can be observed from Figure 5.2 below, while net interest income trend assumed a sharp upward curve for the years 2000 to 2005 inclusive, provision for loan losses assumed until year 2005 a flat trend. This positive relationship is a reflection of their respective annual average growth rates of 24.4% (of net interest income) and 15.3% (of loan loss provisions) for the period under review.

Figure 5.2: Trend of net interest income and loan provisions



The overall relationship translates into a declining trend in the ratio of provision for loan losses to net interest income for the years 2000 to 2005 inclusive as shown in Figure 5.3 below. Though not empirically proved, it can be concluded that BSD's above average (50% to 75%) on-site review of the banking industry's loan portfolio and the various off-site loan monitoring mechanisms might have contributed to this positive result.

As shown in the Figure 5.3 below, the ratio of accumulated loan losses to gross loans and overdrafts deteriorated from 15% in the year 2001 to a high of 18% at the end of year 2002 before improving steadily to close the year 2005 at 13%. Though provisions are subjective,

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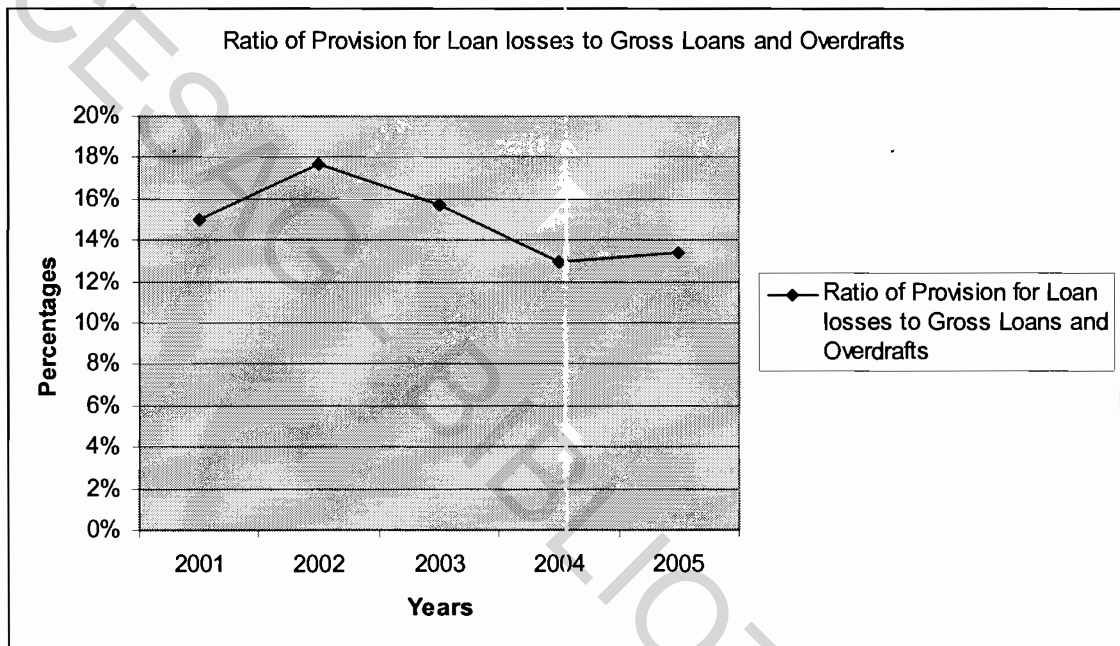
the double digit ratio could be said to be on the high side since on the average every one hundred (100) cedis that was granted as a loan, an amount of thirteen (13) cedis was held as a doubtful debt.

Figure 5.3: Ratio of Provision for loan losses to Gross Loans and Overdrafts



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The above graphical picture is represented in a tabular form below (Table 5.3).

Table 5.3: Provision of loan losses to gross loans and overdrafts

	2001	2002	2003	2004	2005
Gross Loans & Overdrafts (in billion cedis)	6,287	6,869	10,551	12,865	18,334
Accumulated loan losses (in billion cedis)	942	1213	1659	1665	2458
Accumulated loan losses to Gross Loans (%)	15	18	16	13	13

The author believes that the establishment of credit registers in Ghana will greatly assist reduce the bad debt ratio to a single digit (reference to 2.10 on the benefits of credit registers).

Part III of the Banking Act 2004 (Act 673) requires a bank to maintain a certain level of capital adequacy ratio (CAR), which is a cushion against a potential insolvency position. The capital adequacy ratio positions of the banking industry for the years 2001 to 2005 is shown in Table 5.4 below:

Table 5.4: Capital adequacy ratio positions of the banking industry

Year	Statutory CAR (in %)	Actual CAR (in %)
2005	10	27.73
2004	6	13.94
2003	6	9.27
2002	6	13.42
2001	6	14.74

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The Bank of Ghana in its efforts to ensure that banks in Ghana meet the more rigorous requirements of the Basel II, increased the capital adequacy ratio from 6% to 10%, with effect from the year 2005. In the same vein, the Bank of Ghana gave a deadline of December 2006 for all banks operating in Ghana to increase their stated capital to a minimum of ¢70 billion.

Analysis of the above actual capital adequacy ratios indicated that banking industry in Ghana was adequately capitalized for the years 2001 to 2005. It could be concluded that the Bank of Ghana's operational independence which enables it to invoke Sections 27(2) and 28 of the Banking Act 2004 (Act 673) to remedy any persistent capital adequacy deficiency without recourse to Government in power might have contributed to the above satisfactory CAR position. In assessing health and soundness status of banks, the Banking Supervision Department of the Bank of Ghana applies various analytical tools to determine reasonable level of comfortability and tolerance. The financial soundness indicators used by the Banking

Supervision Department in its supervisory process is a fusion of internationally adapted and locally developed indicators.

5.8 Outsourcing of Supervisory Functions

As of June 2006, banking supervisory activities in Ghana were undertaken by the Banking Supervision Department. No aspect of the banking supervisory process was outsourced to any professional third parties such as external auditors or professional firms. However, in matters of liquidation of a bank, the Bank of Ghana duly appoints external auditors to assist in the liquidation process (e.g. to evaluate terminal values of assets and liabilities) in compliance with the Companies Code of Ghana, 1963 (Act 179), the Banking Act, 2004 (Act 673), and accounting standards. The appointment of external auditors in the liquidation process is to ensure that the process is legally compliant, professionally fair, and morally just.

5.9 Depositor Protection Mechanisms

As part of its depositor protection mechanism, the Bank of Ghana provides temporary liquidity support (e.g. in the form of credit) to commercial banks. However, the absence deposit insurance institution in Ghana seems to expose customers to difficulty in full recovery of their deposits in case a bank goes bust since depositors will have to wait for the liquidation proceeds. In a related dimension, there is no credit rating agency yet in Ghana to contribute to imposing moral responsibility on loan customers to repay their loans thereby improving the overall health status of banks in the country. The presence and contribution of a credit rating agency to financial services sector is crucial since their services nonetheless contribute to overall risk management process of banks. As shown in the literature review, we believe that the efficiency and effectiveness of the role of the Banking Supervision Department of the

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Bank of Ghana will be facilitated to a large extent by the existence of deposit insurance institution and credit rating agency.

5.10 Off-site Surveillance

As indicated earlier, though an integrated approach to supervision is adopted by each Examination Unit, the off-site members monitor risk profile of banks through timely receipts of prudential returns, their analysis and generation of relevant reports, the contents of which are communicated to each respective bank. They monitor liquidity risk of banks via statutory reserve assets requirements maintenance and other financial analysis.

In terms of monitoring credit risk profile of banks via prudential returns, quality of loan assets were classified into five timeframes of performance as follows:

i) ***Current***: (not criticized – attracts loan loss provision of 1%);

ii) ***OLEM*** **-Other Loans Especially Mentioned:** (minor credit or other weaknesses are noted for management's attention – attracts loan loss provision of 5% to 15%);

iii) ***Sub-standard***: (displays well-defined credit weaknesses that jeopardize the liquidation of the debt – attracts loan loss provision of 25%);

iv ***Doubtful***: (exhibits all the weaknesses inherent in advances classified as substandard with added characteristics of inadequate collateral security – attracts loan loss provision of 50%); and

v) ***Loss***: (considered uncollectible – attracts a loan loss provision of 100%).

Operational risks are monitored via returns on fraud, internal auditors' reports, external auditors' management letters, and the use of average of three (3) year gross income, which is added to asset base for capital adequacy computation. They monitor legal and reputational

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risks through information and complaints received and/or published in dailies whereas market risk is monitored via a Net Open Position prudential return.

5.11 On-site Examination

The On-site Examination team's operational activities are guided by Section 54 of the Banking Act, 2004 (Act 673), which requires "*the Bank of Ghana to carry out an examination of the operations and affairs of a bank, with reference to its books and records including documents, at intervals of not less than once a year*". BSD however goes beyond the once a year examination in cases where a bank is assessed to have serious operational problems and where a bank is scheduled for liquidation. The team carries out field examination of risks that a bank is exposed to and makes recommendations for remedial actions. Staff are composed into sub-teams and each sub-team spends an average of five (5) weeks on the field, examining a bank and some of its branches. It has been noted that the implementation rate of recommendations of the Unit by the banking industry ranged between 50% and 75% for the years 2002 to 2005 inclusive, posting a simple annual average of 62.5%. The relatively not very high implementation rate could be due to poor review and analysis, non-implementable recommendations, and/or banks' deliberate non-compliance action due to perceived enforcement weaknesses in the old Banking Law, 1989 (PNDCL 225). This weakness has however been addressed by Section 60 of the new Banking Act, 2004 (Act 673), which states inter alia "*the Bank of Ghana may, after examining a bank's explanation issue a directive based on the explanation to that bank to take remedial action that the Bank of Ghana may specify and that bank shall comply with the directive*".

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5.12 Resource Constraints

In order to stay ahead of the banking industry, BSD with the technical assistance of some development agencies and other donor organizations provide various training courses to its staff. Structured in-house (tailored) training courses are carried out weekly whilst local (external) and overseas training courses are carried out as and when necessary. The essential resource base of BSD is its human capital, which enables the department to effectively and efficiently discharge its statutory obligations.

It could be inferred from Table 5.5 below that the growth in BSD's staff strength was strategically positioned to effectively supervise the ever-growing banking industry in Ghana.

Table 5.5: BSD's staff strength

Year	Core (Professional) Staff	Administrative Staff	Total
2005	136	18	**154**
2004	91	20	**111**
2003	85	19	**104**
2002	110	17	**127**
2001	116	17	**133**

However, the department seems to have difficulty in retaining its core staff, who are being enticed by better conditions of service by other financial institutions.

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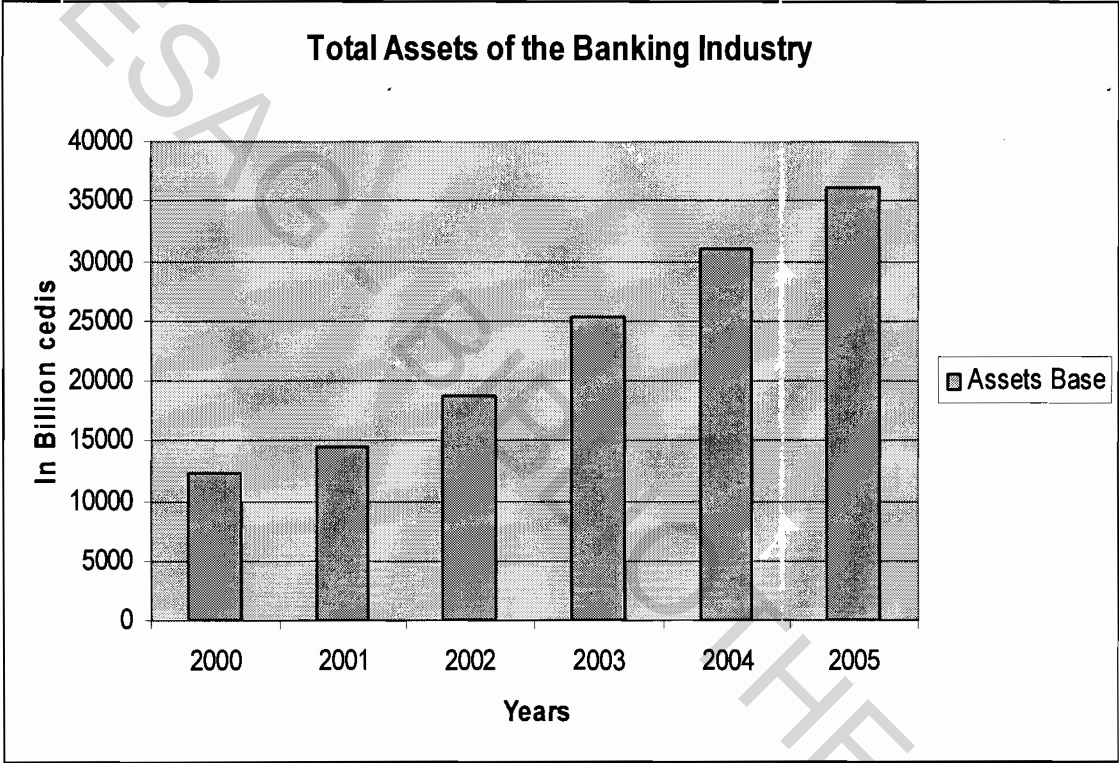
5.13 Asset base of the banking industry

The assets base of the banking industry in Ghana grew steadily from 12,282 billion cedis at the end of year 2000 to 36,219 billion cedis at the end of year 2005 (see Figure 5.4 below), thereby posting approximately an annual average growth rate of 24.2%.

Figure 5.4 Total assets of the banking industry



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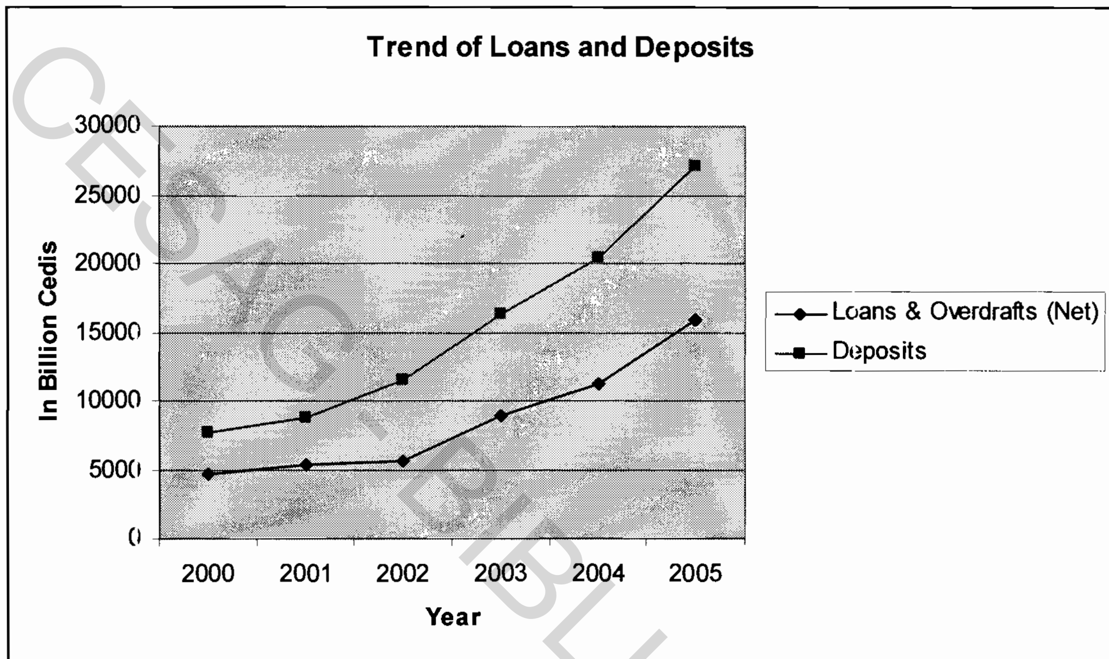
5.14 Deposits and Loans

The banking industry recorded steady growth in deposits (annual average growth rate of 25%) and net loans (annual average growth rate of 27.8%) for the years 2000 to 2005. Whilst deposits increased from 7,604 billion cedis in year 2000 to 27,155 billion cedis in year 2005, net loans went up from 4,654 billion cedis in year 2000 to 15,876 billion cedis in year 2005. These appreciable growth rates attest to aggressive yet cautious financial intermediation

functions by banks in Ghana supported by effective supervisory oversight by the Banking Supervision Department as depicted by Figure 5.5 below:

Figure 5.5: Trend of deposits and loans



The apparent wide gap between the deposit and net loans as shown in the Figure 5.5 above was because the Banking Act, 2004 (Act 673) permits banks to use a maximum of 56% (but 76% from year 2005) of deposits mobilised as loans and keep the balance in liquid/reserve assets with the Bank of Ghana.

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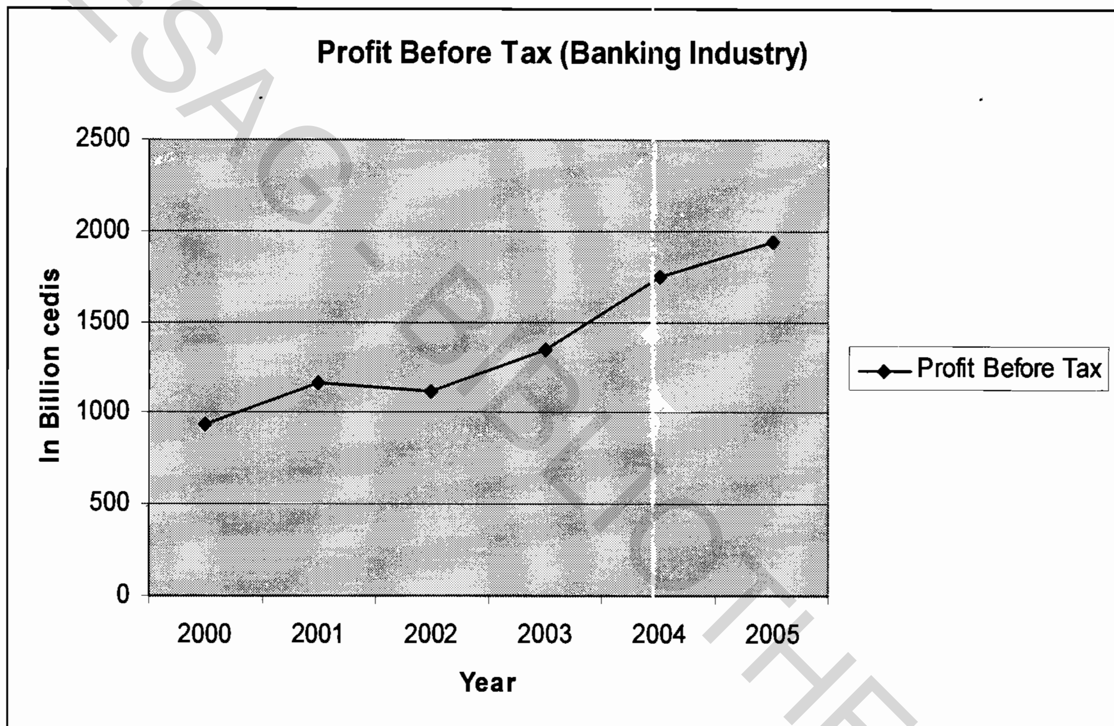
5.15 Profitability of the banking industry

The banking industry's profit before tax grew from 934 billion cedis in year 2000 to 1,940 billion cedis in year 2005 thereby posting a simple annual growth rate of 15.7% as shown in Figure 5.6 below:

Figure 5.6: Profit before tax of the banking industry



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5.16 Trends in Interest Rates

Interest rates declined since year 2001 in line with general improvements in the economy. As shown in Table 5.6 below, borrowing rates on demand deposits declined from 13.5% in the year 2001 to a low of 7.35% at the end of year 2005. Savings deposits, time deposits, certificates of deposits, and call deposits all declined from the year 2001 to year 2005. In the same vein, lending rates also reduced from 43.75 % at the end of year 2001 to close the year 2005 at 27.82%.

Table 5.6: Trends in Interest Rates (annual averages)

	2001	2002	2003	2004	2005
a) DEPOSIT RATES (%):					
Demand deposits	13.50	8.00	8.50	7.5	7.35
Savings deposits	14.50	11.13	11.09	9.5	8.00
Time deposits (3 months)	23.25	16.22	14.28	13.25	9.66
Certificates of deposits	18.00	14.56	15.79	12.25	10.32
Call deposits	17.00	12.17	12.52	9.25	7.63
b) LENDING RATES (%)	**43.75**	**36.36**	**34.95**	**28.75**	**27.82**
c) PRIME RATE (%)	**27.00**	**24.50**	**25.50**	**16.50**	**15.50**

Source: Bank of Ghana Statistical Bulletins (2001 to 2005)

The gap between the borrowing rates and lending rates though on the decline gradually, makes Ghana's banking industry one of the most lucrative in the West African sub-region, which has seen an influx of new banks since the year 2004. With the liberalisation of the banking industry since 1989, the Bank of Ghana no more control interest rates in the country but attempts to influence them through its prime rates (used as the main monetary policy signaller), which is announced from time to time. As can be observed from Table 5.6 above, the decline in both the borrowing and lending rates follow the decline in the trend of the prime rate from 27.00% in the year 2001 to 15.50% at the end of year 2005.

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CHAPTER 6

6.0 FINDINGS, RECOMMENDATIONS, AND CONCLUSION

6.1 Introduction

The Bank of Ghana Act, 2002 (Act 612) and the Banking Act, 2004 (Act 673) jointly confer statutory obligations on the Bank of Ghana to ensure establishment, sound operation, supervision, and liquidation (where necessary) of banks in Ghana. To fulfill this objective, the Bank of Ghana established the Banking Supervision Department to be responsible for regulation and supervision of banks in Ghana. The broad objective is to position banks to effectively and efficiently undertake financial intermediation and management of both national and international payment systems, with the ultimate aim of contributing to overall human welfare and economic growth.

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6.2 Findings

The study has revealed the following findings:

i). The Banking Supervision Department (BSD) was established in compliance with statutory provisions with a clear objective to ensure safe, sound, and stable financial system, ensure consumer/depositor protection, fair competition, and facilitate effective and efficient payment system. BSD was therefore structured into manageable Units with specific goals aimed at realisation of its ultimate objectives. The activities and operations of BSD are guided by a strategic plan. The current strategic plan of the BSD is a five (5) year plan, spanning the years 2005 to 2009.

ii). Staff of BSD undergo periodic local and overseas training courses aimed at ensuring that they acquire relevant knowledge, improve their skill levels, and stay ahead of the banking

industry. However, BSD's core staff is under threat of being poached by other banks and financial institutions that seem to offer more attractive conditions of service.

iii). BSD monitors risk profile of banks via on-site examination, prudential returns with varying timeframes of submission, relevant publications in the press, complaints and reports received from the public, internal audit reports, and management letters of external auditors. The nature and timeframe of the prudential returns were found to be adequate in capturing salient regulatory and supervisory information. The banking industry's compliance rate of an average of 97.5% in terms of timely, completeness and accurate submission of prudential returns was found to be satisfactory. Ghana was however yet to have a credit rating agency to contribute to overall risk management process of the banking industry.

iv). The health and soundness of the banking industry in Ghana for the period 2001 to 2005 was evaluated principally using the industry's liquidity and solvency positions and was found to be satisfactory. However, the accumulated loan losses to gross loans ratio which averaged 13% per annum for the same period seemed to be on the high side.

v). The provisions of the new Banking Act, 2004 (Act 673) as a fundamental regulatory and supervisory framework was found to be adequate in terms of establishment, operation, supervision, and liquidation of banks in Ghana.

vi). Though the primary and secondary reserve requirements are aimed at supporting monetary policy targets, they indirectly provides protection to depositors in times of liquidation. Ghana was yet to have a deposit insurance institution, which offers a more rigorous and full protection to depositors against their deposits, improves public confidence,

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and deepens financial intermediation as well as achieves stability in financial markets. Despite the positive contributions of deposit insurance, some academicians and professionals believe that its presence promotes moral hazard as noted in the literature review.

vii). The study reveals a weakness in the Banking Act, 2004 (Act 673) to the effect that the Bank of Ghana may not be entirely politically independent, because some of its decisions could be overridden by the Minister of Finance as observed in Chapter three of the study. An instance is where a person whose application for a banking licence is declined by the Bank of Ghana has the option to petition the Minister of Finance in writing. Upon receipt of the petition, the Minister of Finance shall refer the matter to a panel of three experts, one chosen by the Bank of Ghana and two by the Minister of Finance. The panel shall prepare a report which shall be submitted to the Minister of Finance for his decision.

viii). The banking supervision model being used by the BSD of the Bank of Ghana was more of the United States model. According to the literature (refer Chapter two), this model gives a better satisfaction and assurance to the regulatory authorities but it is labour intensive and can be inhibited by budgetary constraints.

ix). The BSD uses a combination of internationally adapted indicators and locally developed financial soundness indicators in its supervisory process of the banks.

x). The total assets of the banking industry in Ghana grew at a simple annual average rate of 24% for the years 2000 to 2005 inclusive. In terms of financial intermediation for the same period, deposits and loans grew at simple annual average rates of 25% and 28% respectively.

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The banking industry's profit before tax witnessed an upward trend for the same period while borrowing and lending rates assumed declining trends.

xi). The BSD carries out on-site examination of each bank once a year in compliance with the Banking Act, 2004 (Act 673), which also conforms to international standards. From the analysis, one can however conclude that the BSD's inability to conduct on-site examination of each bank more than once a year may be due to resource (human and logistics) constraints. Nonetheless, when a bank faces precarious liquidity and/or solvency problems the BSD monitors its performance more closely than the other sound banks and therefore conducts on-site examination more than once in a year. This approach is line with the new paradigm shift of risk focus supervision being adopted across the globe.

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6.3 Recommendations

As noted in chapters three and five, the banking industry in Ghana is becoming more competitive and complex and at the same time the investing public is also becoming more sophisticated. A way to stay competitive in the industry is for banks to develop more sophisticated products with various risk profiles aimed at meeting the taste of the customers. This therefore requires the BSD to be extra vigilant in monitoring and identifying risks inherent in the operational activities of banks operating in Ghana. Based on our findings, the following recommendations are made for consideration by management of the BSD of the Bank of Ghana:

i). Establishment of a credit rating agency in Ghana to contribute to the overall risk management process in the banking industry.

ii). Establishment of a deposit insurance institution in Ghana to provide more protection to depositors, contribute to improving public confidence in the banking industry as well as deepening financial intermediation process.

iii). Since banking industry plays a critical role in ensuring economic growth and general human welfare, staff of the BSB would have to be motivated through regular relevant training courses and other forms of incentives to be able to effectively regulate and supervise the banking industry in the country.

iv). Some of the supervisory costs, specifically the on-site supervision cost should be passed onto the banks, especially since the BSD adopts the more expensive United States of America's model of banking supervision.

v). Adopting a risk based supervision to optimally manage scarce resources while at the same time effectively supervising the commercial banks.

vi). Establishment of a credit register/bureau with its accompanying bad debts register/bureau.

vii). Revision of the Banking Act, 2004 (Act 673) to confer absolute autonomy and independence on the Bank of Ghana thereby removing that aspect of the provision which grants powers to the Minister of Finance for decisions concerning a decline of an application for a banking licence.

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6.4 Conclusion

The Banking Supervision Department has so far played a crucial role in ensuring that the banking industry in Ghana is safe and sound. This achievement has been made possible by the rigorous underlying statutes, directives, vigilance and commitment on the part of the staff of the department. With the dynamism that has characterised today's information communication and technology that drives operations of banks, the tasks of regulatory and supervisory authorities are becoming more demanding and will therefore require more resource commitments, paradigm shift in the approach to supervision, and top managerial support to ensure the existence of safe and sound financial system.

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APPENDIX 1

QUESTIONNAIRE

TO: THE HEAD OF BANKING SUPERVISION DEPARTMENT, BANK OF GHANA, ACCRA - GHANA

TOPIC: ***BANKING SUPERVISION IN GHANA: A DILEMMA OF VALUE AND COST?***

Please provide answers to the following questions (Thank you for your time, cooperation, and accuracy of answers)

1). When was the Banking Supervision Department established at the Bank of Ghana?..

2). Please list key objectives of the Banking Supervision Department (BSD)?
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3). Please list the main functions of the following Units of BSD in Ghana.

a) Off-site supervision unit:
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b) On-site examination/supervision unit
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c) Follow-up unit

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d) Investigation and Customer Reporting unit:

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e) Policy and Licensing unit

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f) Administrative and secretarial unit

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g) Others (**please specify**)....................................

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4). Please provide any relevant supplementary information regarding point (3) above:

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5). With respect to Capital Adequacy deficiency, can you invoke Sections 27(2) and 28 of the Banking Act, 2004 (Act 673) without recourse to government in power?

YES [ ] NO [ ]

6). Please provide reasons for your answer to question (5) above.

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7). What is the staff strength of BSD at the end of the following years?

Year (end)	**Core Staff**	**Admin. staff**	**Total**
2005	…………	……………	……..
2004	…………	……………	……..
2003	…………	……………	……..
2002	…………	……………	……..
2001	…………	……………	……..

8). How is BSD's budget funded? (please tick as many as are appropriate)

a) Consolidated fund [ ]
b) Internally-generated funds [ ]
c) Fees by commercial banks [ ]
d) Donor funds [ ]
e) Others (**please specify)**……………………[ ]

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9). Please provide any relevant supplementary information regarding point (8) above:
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10). Please provide BSD's annual budget for the following years:

Year	**Annual Budget** (please indicate **currency** of budget)
2006	....
2005	....
2004	....
2003	....
2002	....

11). How are the staff of BSD trained? (please tick as appropriate)

a) Structured in-house trainings:
Weekly [ ]
Monthly [ ]
Quarterly [ ]
Bi-annually [ ]
Others (**pls. specify**)........... [ ]

b) Local (external) training courses.
Weekly [ ]
Monthly [ ]
Quarterly [ ]
Bi-annually [ ]
Others (**pls. specify**)........... [ ]

c) Overseas training courses
Monthly [ ]
Quarterly [ ]
Bi-annually [ ]
Others (**pls. specify**)........... [ ]
As and when relevant [ ]

d) You may provide any relevant supplementary information to the training of the supervisors.
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12). How many times (frequency) does the BSD conduct on-site supervision/examination per commercial bank per year?

Once [ ]
Twice [ ]
Thrice [ ]
Others (**pls. specify**)………… [ ]

13). Please provide reason(s) for your answer to question (12) above and add any relevant supplementary information.

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14). Under what circumstances will the BSD conduct on-site examination more frequently per bank per year than your answer to question (12) above.

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15). Does the BSD have a departmental strategic plan?

Yes [ ] No [ ]

16). If your answer to question (15) above is YES, then please specify the period (years) covered by the strategic plan: ………………………………

17). If your answer to question (15) above is NO, please provide reason(s) for the non-existence of the strategic plan.

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18). What is the Compliance Rate of the implementation of BSD's recommendations to on-site examination findings by the banking industry in the following years:

	2005	2004	2003	2002
Less than 25%	[ ]	[ ]	[ ]	[ ]
26% to less than 50%	[ ]	[ ]	[ ]	[ ]
50% to less than 75%	[ ]	[ ]	[ ]	[ ]
75% and above	[ ]	[ ]	[ ]	[ ]

19). On the **average,** how long (duration) does the on-site supervision team stay on the field per bank? ....

20). Does the BSD top management meet with the top management of commercial banks to discuss matters of concern?

a) Programmed Meetings: YES [ ] NO [ ]

b) Unprogrammed Meetings: YES [ ] NO [ ]

21). If your answer to question (20a) above is YES, how often do you meet with them in one calendar year?

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22). If any of your answers to question (20) above is NO, please provide reason(s):
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23). What is the total number of commercial banks (excluding rural and community banks) in Ghana at the end of the following years?

Year (end)	No. of Commercial Banks	No. of Branches
2005	....	....
2004	....	....
2003	....	....
2002	....	....
2001	....	....

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24). On the **average**, what is the default rate (banking industry as a whole) of **non-submission** of periodic prudential returns in the following years?

	2005	**2004**
Zero%	[ ]	[ ]
Above zero% to less than 5%	[ ]	[ ]
Above 5% to less than 10%	[ ]	[ ]
Above 10% to less than 15%	[ ]	[ ]
Others (**pls. specify**)...........	[ ]	[ ]

25). On the **average,** what is the default rate (banking industry as a whole) of **incomplete submission** of periodic prudential returns in the following years?

	2005	**2004**
Zero%	[ ]	[ ]
Above zero% to less than 5%	[ ]	[ ]
Above 5% to less than 10%	[ ]	[ ]
Above 10% to less than 15%	[ ]	[ ]
Others ( )	[ ]	[ ]

26). On the **average,** what is the default rate (banking industry as a whole) of **delayed submission** of periodic prudential returns in the following years?

	2005	**2004**
Zero%	[ ]	[ ]
Above zero% to less than 5%	[ ]	[ ]
Above 5% to less than 10%	[ ]	[ ]
Above 10% to less than 15%	[ ]	[ ]
Others (**pls. specify**)...........	[ ]	[ ]

27). On the **average,** what is the default rate (banking industry as a whole) of **inaccurate submission** of periodic prudential returns in the following years?

	2005	**2004**
Zero%	[ ]	[ ]
Above zero% to less than 5%	[ ]	[ ]
Above 5% to less than 10%	[ ]	[ ]
Above 10% to less than 15%	[ ]	[ ]
Others (**pls. specify**)...........	[ ]	[ ]

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28). Please provide Capital Adequacy Ratio (CAR) of the banking industry as a whole at the end of the following years.

Year (end)	**Actual CAR (in %)**	**Statutory CAR (in %)**
2005	....	....
2004	....	....
2003	....	....
2002	....	....
2001	....	....

29). Please provide Liquidity Ratio (aggregate of both primary and secondary) of the banking industry at the end of the following years:

Year (end)	**Actual (in %)**	**Statutory (in %)**
2005	....	....
2004	....	....
2003	....	....
2002	....	....
2001	....	....

30). Does BSD hold periodic meetings with Board of Directors of each commercial bank?

YES [ ] NO [ ]

31). Please provide reason(s) for answer to question (30) above.

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32). Does BSD have Financial Soundness Indicators?

YES [ ] NO [ ]

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33). If your answer to question (32) above is YES, what is the nature of these Financial Soundness Indicators? Please tick as appropriate.

Wholly internationally adopted	[ ]
Internationally adapted	[ ]
Locally developed	[ ]
Others ( )	[ ]

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34). Do you apply these indicators in your supervisory operations?

YES [ ] NO [ ]

35). If your answer to question (34) above is NO, please provide reason(s).

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36). What are BSD's annual budgetary allocations as a percentage of the Bank of Ghana's annual budgetary allocations for the following years:

2006 ....

2005 ....

2004 ....

2003 ....

2002 ....

37). Have you outsourced any aspects of supervisory activities to external auditors?

YES [ ] NO [ ]

38). Please provide reason(s) for your answer to question (37) above.

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39). What constraints confront BSD in effectively and efficiently discharging its statutory responsibilities and functions?

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40). What is the current minimum capital requirement for establishing a commercial bank in Ghana?..

41). What percentage of the banking industry's (excluding rural and community banks) credit portfolio did you review during on-site examinations for the following years:

	2005	**2004**	**2003**
Less than 25%	[ ]	[ ]	[ ]
26% to less than 50%	[ ]	[ ]	[ ]
50% to less than 75%	[ ]	[ ]	[ ]
75% and above	[ ]	[ ]	[ ]

42). Do commercial banks always effect entries of BSD's on-site examination recommendations for provisions for loan losses?

YES [ ] NO [ ]

43). If your answer to question (42) above is NO, please provide reason(s).

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44). If your answer to question (42) above is YES, what mechanisms do you have in place to monitor that the entries are not reversed afterwards/later?

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45). Do you think establishment of credit rating agency(ies) in Ghana will facilitate your supervisory work?

YES [ ] NO [ ]

46). Please provide reason(s) for your answer to the question (45) above.

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47). What off-site supervisory mechanisms/tools do you use to identify and monitor credit risk of commercial banks?

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48). What off-site supervisory mechanisms/tools do you use to identify and monitor liquidity risk of commercial banks?

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49). What off-site supervisory mechanisms/tools do you use to identify and monitor operational risk of commercial banks?

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50). What off-site supervisory mechanisms/tools do you use to identify and monitor management risk of commercial banks?

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51). What off-site supervisory mechanisms/tools do you use to identify and monitor other risk (legal, reputational, market, etc) of commercial banks?

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52). Do you evaluate and rate each commercial bank's risk and performance profile after each on-site examination?

YES [ ] NO [ ]

53). If your answer to question (52) above is NO, please provide reason(s).

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54). If your answer to question (52) above is YES, please provide attachment of the rating methodology framework.

55). Please list and explain any customer protection structures/mechanisms in Ghana such as deposit insurance, lender-of-last, etc (apart from the legal provisions enshrined in the Banking Law, Act 673).

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56). How often do you review and revise the format of the prudential returns? (You may provide reasons for answer).

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57). To what extent do supervisors rely on the work of external auditors and internal auditors in performing their supervisory work (please explain).

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58). Please provide a **summary breakdown** of the **type and number** of financial institutions supervised by the Banking Supervision Department of the Bank of Ghana.

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ATTACHMENTS REQUIRED (please attach)

1). Current organogram of BSD (organisational chart) (**Attachment 1**).

2). Banking industry data (aggregate of the industry) of audited accounts (Profit and Loss account and Balance sheet) for the years 2005, 2004, 2003, 2002, 2001, 2000 (**Attachment 2**).

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3). Ownership structure of each commercial bank at the end of the financial year 2005 in the following format (**Attachment 3**).

Name of Bank	**Domestic Shareholding (%)**	**Foreign Shareholding (%)**
…………..	……………………..	……………………..
………….	……………………..	……………………..

4). A list of all prudential returns that commercial banks in Ghana are required to submit to the BSD in the following format (**Attachment 4**).

Type of Return	**Name of Return**	**Frequency of Submission**	**Time Limit for Submission**
………	……….	……………	…………..
………	……….	……………	…………..

5). BSD's rating methodology framework (**Attachment 5).**

6). Please attach and/or provide any other relevant data and/or information on the subject matter.

Once again, thank you very much for the assistance.

SIGNATURE:………………………………….. **DATE:**………………

STAMP:……………………………………………

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