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Short communication

Banking industry liberalisation in Ghana

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Abstract

Economic liberalisation is characterised by the entry of foreign companies and the emergence of new domestic institutions to compete with the existing institutions of lending, and there is a view that the process leads to greater efficiency, especially because foreign banks bring new expertise. Extracting information from accounts lodged with Ghana Central Bank, this paper ranks the cost efficiency of banks, Theil decomposition of the cost efficiency scores allows for a comparison of performance between banks under different types of ownership. There is pronounced differences in efficiency scores within and between groups by type of ownership, but foreign ownership, per se, is not the determining factor.

JEL classification: G2; L8; N2; O2

Keywords: Africa; Ghana; Financial liberalisation; Foreign banks; Domestic banks; Public sector

1. Introduction

Financial liberalisation entails diversity in ownership and governance structures of banks, and we are concerned with comparing the efficiency of different ownership structures. However, liberalisation has taken different forms in different countries because the model of perfect competition underlying the idea of full liberalisation does not apply to banking. There are different types of liberalisation requiring different ways of measuring the success of reform carried out within the constraints of the particular type of liberalisation under consideration.[1] Comparison of efficiency between different types of banks becomes country specific. We are concerned with measures of bank efficiency in post-liberalisation Ghana.

Efficiency and productivity are problematic concepts (Saraydar, 1989; Uddin and Hopper, 2003) and they are doubly problematic in the service sector. For example, an industry might be characterised by firms that make best use of inputs, within the constraints of extant knowledge, in production without making any further advances on new methods of production or delivery. The problem is further complicated in the service sector where inputs and outputs cannot always be clearly delineated, and this further difficulty is highlighted in the literature on bank performance. Assets of banks are the deposits and loans, loans are re-deposited, and deposits are lent out again. Notwithstanding these difficulties, there is consensus in the literature about certain particular indicators of efficiency which might help in the conduct of informed policy debate about the intermediation role of banks. Being concerned with the debate about financial sector liberalisation, this paper focuses on the banking industry.

The intermediation approach to modelling bank production posits that banks mediate between depositors and borrowers. From this perspective, a bank purchases inputs (deposits) in order to generate earning assets (loans) as output (Sealey and Lindley, 1977), and adding value in the process.

The attainment of full allocative efficiency in a free market entails that risk-adjusted interest rates equalise risk-adjusted returns across all borrowers and lenders. Market efficiency, as that concept is understood above, is inadequate to capture gains and losses to the economy from liberalisation if either there are

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[1] For example, liberalisation in the United States had meant the repeal of the Glass-Steagal Act restricting the range of activities a bank could carry out (Ibanez et al., 2010).

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interactions between industries and second best problems arise or there is information deficiency in market contracts.[2]

Competition can increase even when reform of the financial sector is carried out within the context of an industrial strategy for the allocation of funds, as was done in South Korea (Amsden and Euh, 1993).[3] To study the impact of liberalisation on the efficiency of banks, it may be fruitful to examine "*functional efficiency*, [measured as] the productivity of the delivery of financial services" (Amsden and Euh, 1993:387). Increase in competition is a likely factor in reducing cost of delivery (Mahesh and Bhide, 2008), but there may be institution-specific constrains on the outcome reflecting differences in ownership structure.[4]

The process by which reforms in the banking system may contribute to cost efficiency is outlined by Jae Yoon Park (1988:13) narrating the Korean experience (quoted in Amsden and Euh (1993:387):

> "The managers and employees of financial institutions have acquired more of a competitive spirit. They have become very sensitive to the earnings and expenses of financial institutions . . .These may be considered the most important performance-effects that the first round of liberalization has achieved."

Our paper examines the distribution of cost efficiency amongst Ghanaian banks during the period 1997–2008, when the initial impacts of the reform process that started in 1986 were bedded down. Data that are available for banks are pooled together and grouped by ownership criteria and also by a two category entry period, those that were already established in the pre-liberalisation period before 1986 and those that entered subsequently.[5]

There is a view, for example the view informing the Narasimham Committee (Narasimham Committee Report, 1991) constituted by the Reserve Bank of India to advise on financial sector liberalisation in that country, that the entry of foreign banks and the emergence of new domestic private banks introduce better management techniques in the banking industry. There is no consensus about how long it might take for these new techniques to be impounded within the entire industry and opinion varies, especially, about the desirable pace of reduction in barriers to foreign competition (Joseph and Nitsure, 2002). A way of examining the impact of liberalisation on efficiency is to examine whether the new entrants as a group have brought more cost efficient practices into the banking system which persist even after some years to distinguish the performance of these groups of banks from the rest. This is one aspect of our study.

Another aspect is an examination of the importance of ownership structure, for example whether private ownership continues to lead to greater pressure for cost efficiency than public ownership even some years after liberalisation when public sector banks are granted greater commercial autonomy, and minority equity holdings in these banks are traded in the bourse.

To examine the distribution of cost efficiency amongst banks, a cost efficiency frontier is estimated. The distance of a bank from this frontier can be regarded as a proxy for managerial slack, a measure of inefficiency, in that bank. Efficiency is measured as the corollary, closeness to the frontier.

The paper is organised as follows. Section 2 describes the background to financial liberalisation in Ghana, and outlines the data. Section 3 explains how the cost efficient frontier is estimated and distance from the frontier is calculated for banks. Section 4 reports the results, and Section 5 concludes.

2. Background

The shift in thinking in development economics in favour of greater emphasis on the market began to make a mark on the direction of economic policy in Ghana in the 1980s. The reform of the financial sector, which began in 1986, was an inevitable component of the policy of embracing the market. Ever since the reforms were implemented in the Ghanaian banking industry, the influx of privately-owned banks (both domestic and foreign) has increased steadily.

Before the reforms began in 1986, there were only 11 banks operating in the economy, of which four had foreign equity participation. Foreign participation was limited to 60% of total equity by an indigenisation decree passed in 1975. The government acquired 40% of equity stake in hitherto fully-owned subsidiaries of foreign banks. Since the start of reforms, the government has sold its minority shares in these banks. To distance government from financial markets further, government's equity stakes in the public sector banks have been diluted by sale to the public through listing in the stock exchange.[6]

As of December 2008, there were 25 deposit taking banks in operation, of which 13 were foreign-owned and 9 were under domestic private ownership. Three banks remained in the public sector. Whilst the pressure of public opinion has exerted a restraint on privatising fully the remaining stake of government in the public sector banks, there has been considerable entry, exit and re-structuring of institutions. A number of banks, both in the public and private sector and some of them even

[2] The problem of externality is an important but neglected area of research in the literature on bank liberalisation with some notable exceptions (e.g. Stein, 2010). Banks have a greater external impact on other sectors of the economy than most other firms, but this externality is not picked up in conventional measures of efficiency deriving from the literature in industrial economics. For example, Stein (2010) argues that privatised banks in some countries have withdrawn from providing services to the small and medium sized industries because the information cost is greater but the cost to the economy of depriving funds to these sectors is high. Thus the issue about how to measure bank efficiency is not a settled question. This is an important issue but it is outside the scope of this paper.

[3] Amsden and Euh (1993) is a study of the impact of banking sector reform in South Korea where the state did not fully distance itself from lending decisions.

[4] Increase in competition in banking which may reduce cost of delivery is not to be conflated with increased productivity elsewhere in the economy (Valvarde et al., 2003).

[5] Ownership criteria are explained in the notes following Table 1.

[6] One of these institutions (Social Security Bank) was eventually merged and acquired domestically and subsequently merger with and acquisition by a foreign bank.