"High Lending Rates in Ghana: What is the Solution?"

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"High Lending Rates in Ghana: What is the Solution?

By

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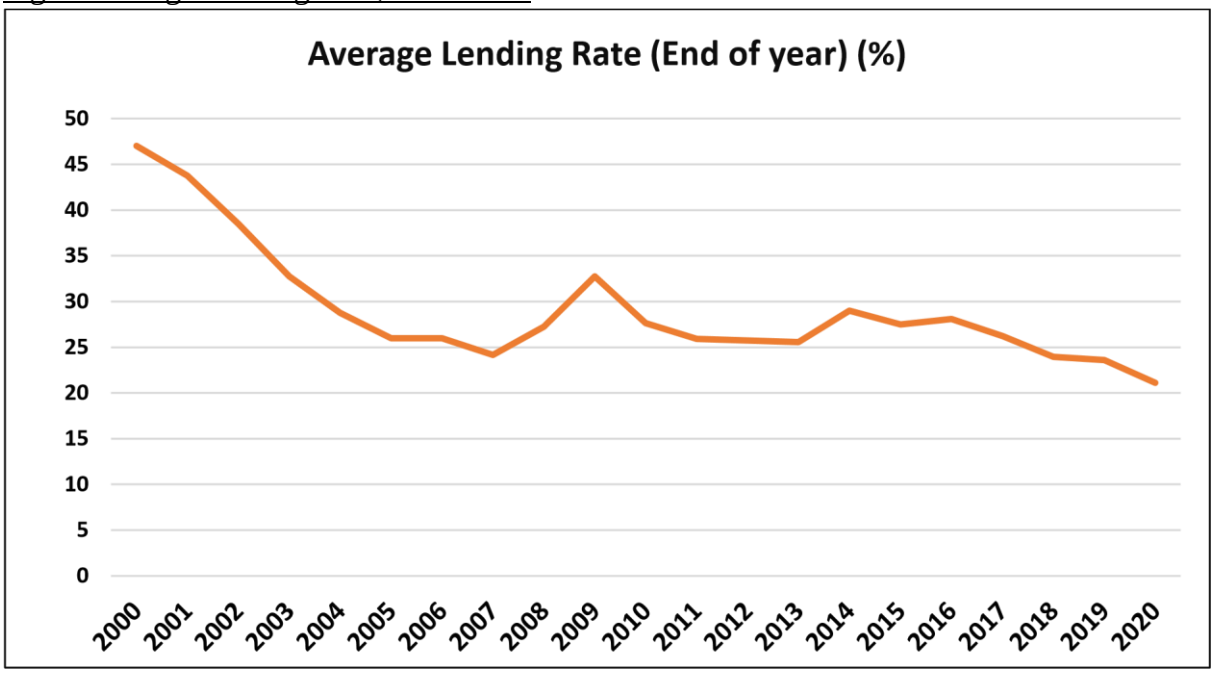
1. THE PROBLEM OF HIGH LENDING RATES

When inaugurating the new Bank of Ghana Board on August 20, the President expressed concern about the high lending rates in the country and the negative impact on growth. He called out the Board to address the problem as a matter of urgency. The Governor pledged the Board's commitment to take the necessary steps to address the issue.

We wish to recall that prior to 1983, interest rates—both lending and deposit rates—were controlled—literally fixed—by the monetary and regulatory authority (MRA). This kept lending rates contained. In 1983, Ghana adopted wide-ranging liberal economic policies under an Economic Recovery Programme (ERP). Interest rates were deregulated as part of the new liberal policies. Since then, lending rates, along with other nominal price-variables, began to assume their "true" levels. Fig. 1 captures the trend of the average lending rate for all banks spanning the 20-year period, 2000-2020

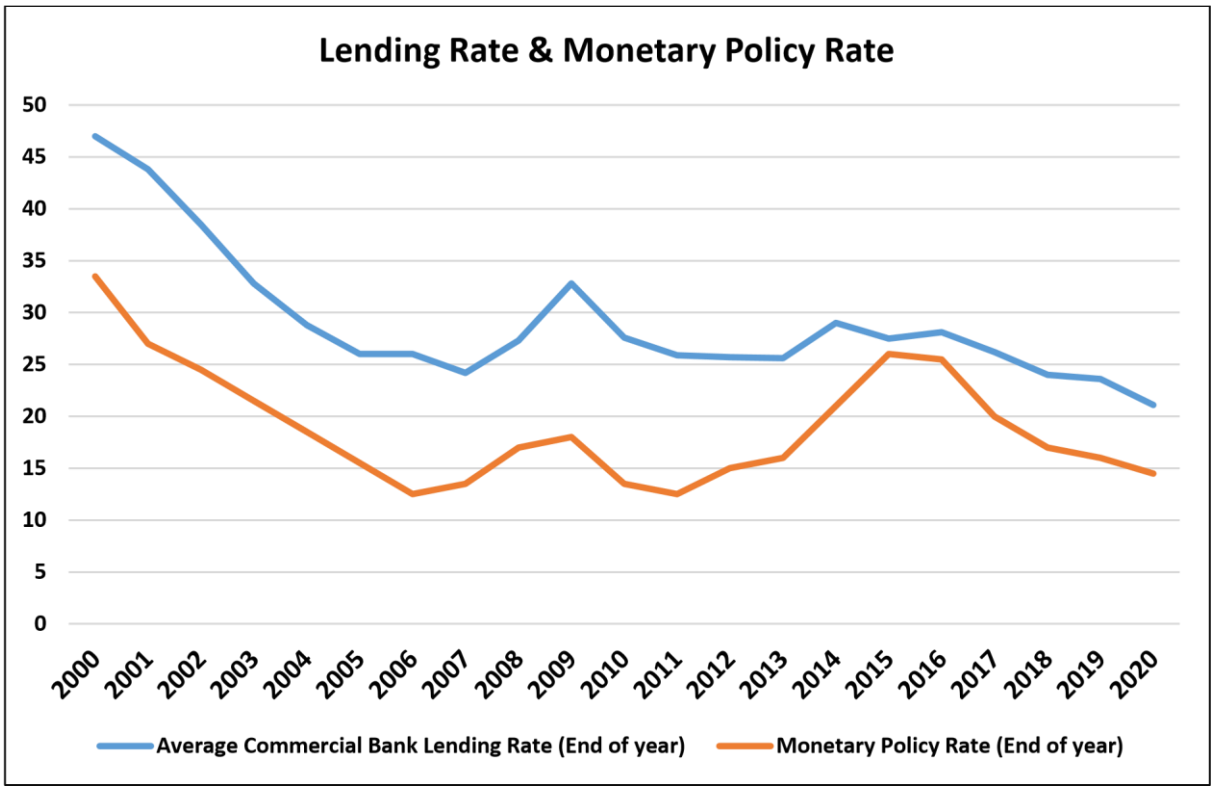
Fig 1: Average Lending Rate, 2000-2020



During 2000-2020, the lending rate averaged about 27% yearly, although it followed a downward trend during the period. The yearly average of 27% is quite high. High lending rates are concerning as they constitute a drag on investment, production and economic growth while also being a source of inflation as they feed into the cost of production.

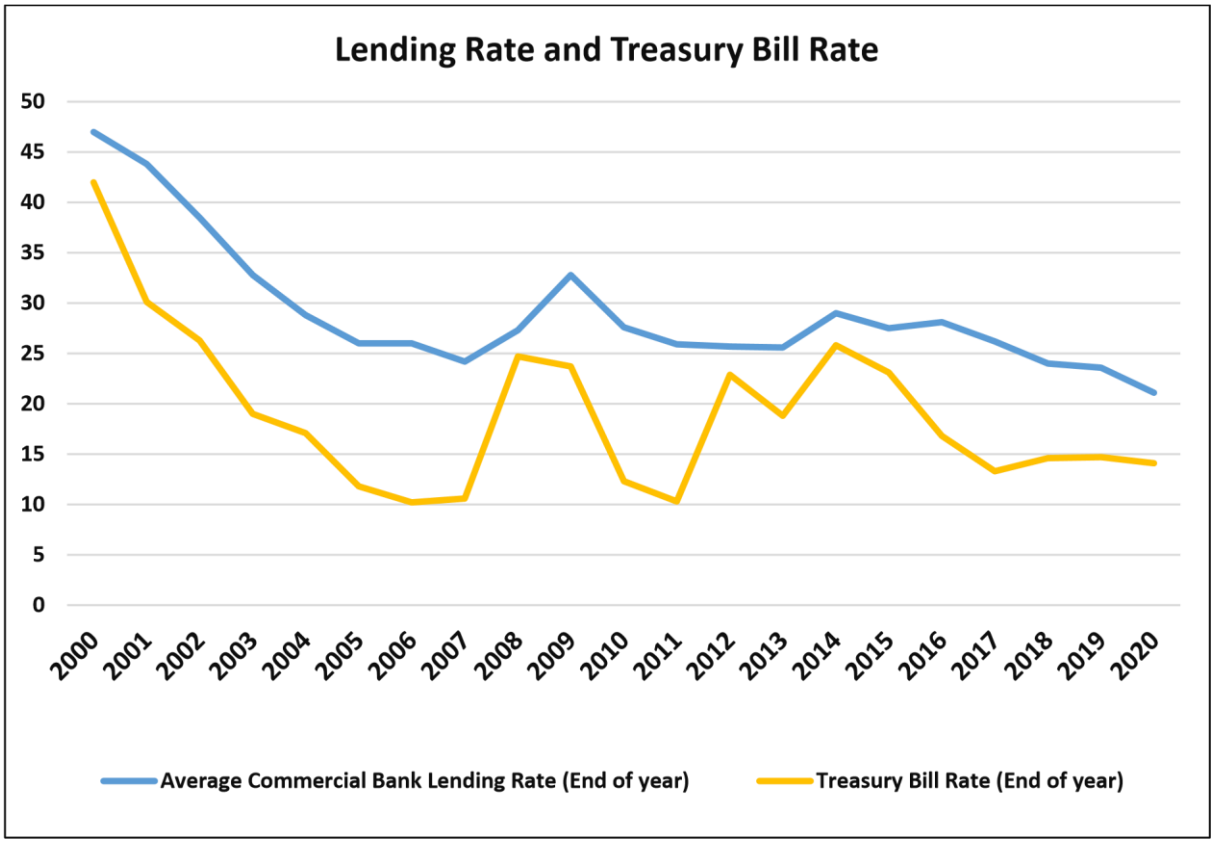
Not only has the level of the lending rate been high, but so also have been the spreads between the lending rate and other key interest rates and inflation (Figs. 2-5).

Fig 2: The Lending Rate and Policy Rate, 2000-2020



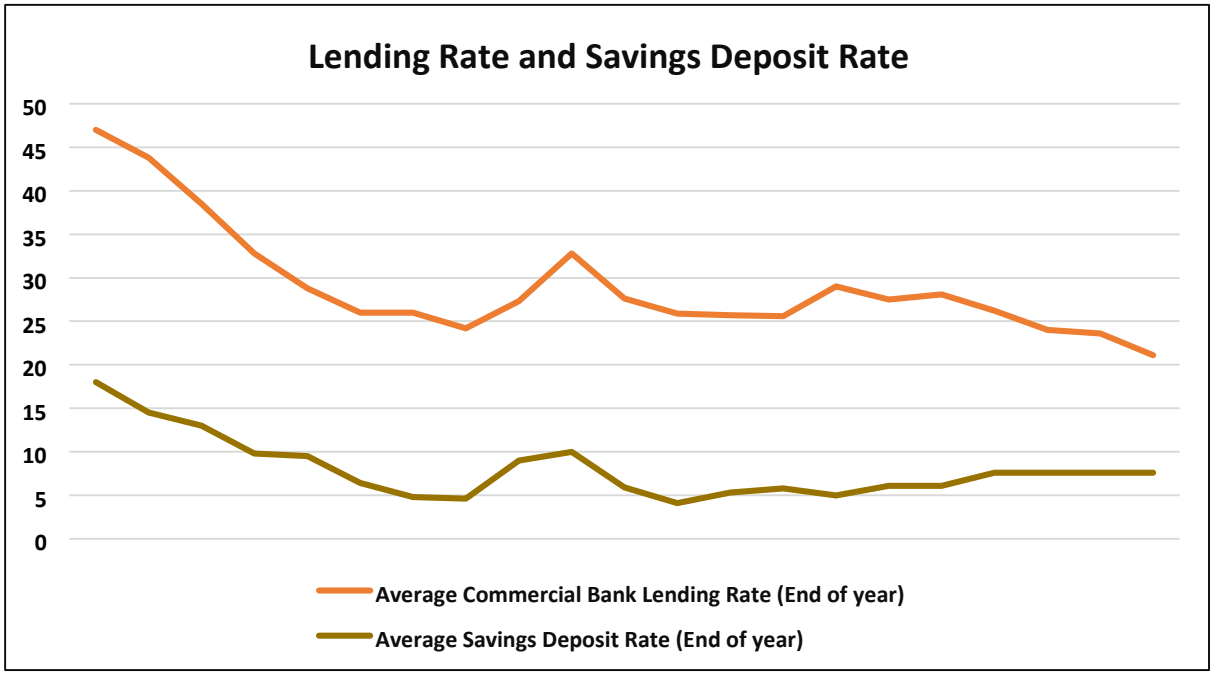
The lending rate has generally followed the Policy Rate. However, the spread between two has averaged about 10 percentage points yearly during 20200-2020, although it has narrowed in recent years. The yearly average spread is high by international standards. It should not normally exceed 4-5 percentage points. The high spread is a sign of low sensitivity of the lending rate to the Policy Rate. This is a phenomenon called low transmission of monetary policy, which renders monetary policy less effective.

Fig 3: Lending Rate and Treasury Bill Rate, 2000-2020



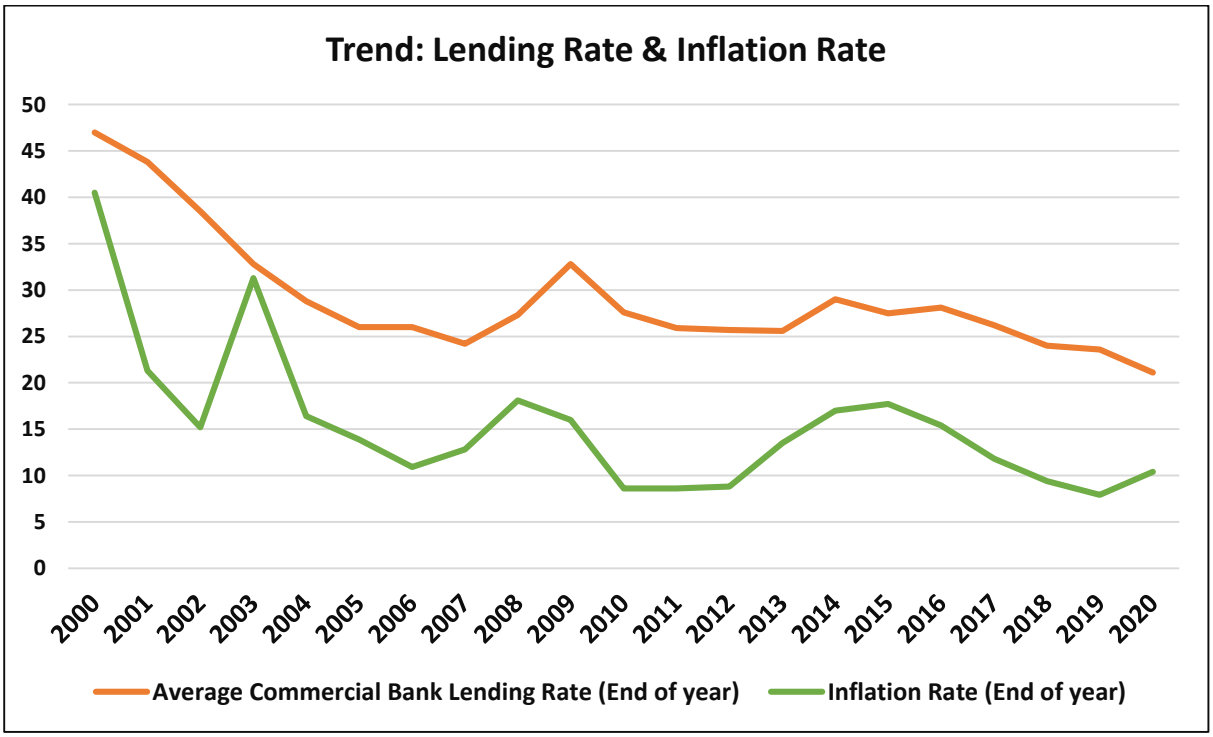
The spread between the lending rate and the Treasury Bill Rate averaged 10 percentage points yearly during 2000-2020. It is understandable why the lending rate will be higher than the Treasury Bill rate since lending to the private sector carries more risk than lending to Government, which is near risk-free. But the average margin of 10 percentage points is still high.

Fig 4: Lending Rate and Savings Deposit Rate, 2000-2020



The spread between the lending rate and the savings-deposit rate averaged 20 percentage points yearly during 2000-2020, although it has been on a declining trend. The yearly average spread is too high and is symptomatic of several defects in the financial industry, including high costs, high borrower risks, collusive behaviour and "customer capture."

Fig 5: Lending Rate and Inflation, 2000-2020



The spread between the lending rate and the inflation rate (or the real lending rate) averaged 12 percentage points yearly. Again, this margin is too wide.

Fig 6: Selected Interest Rates, 2000-2020

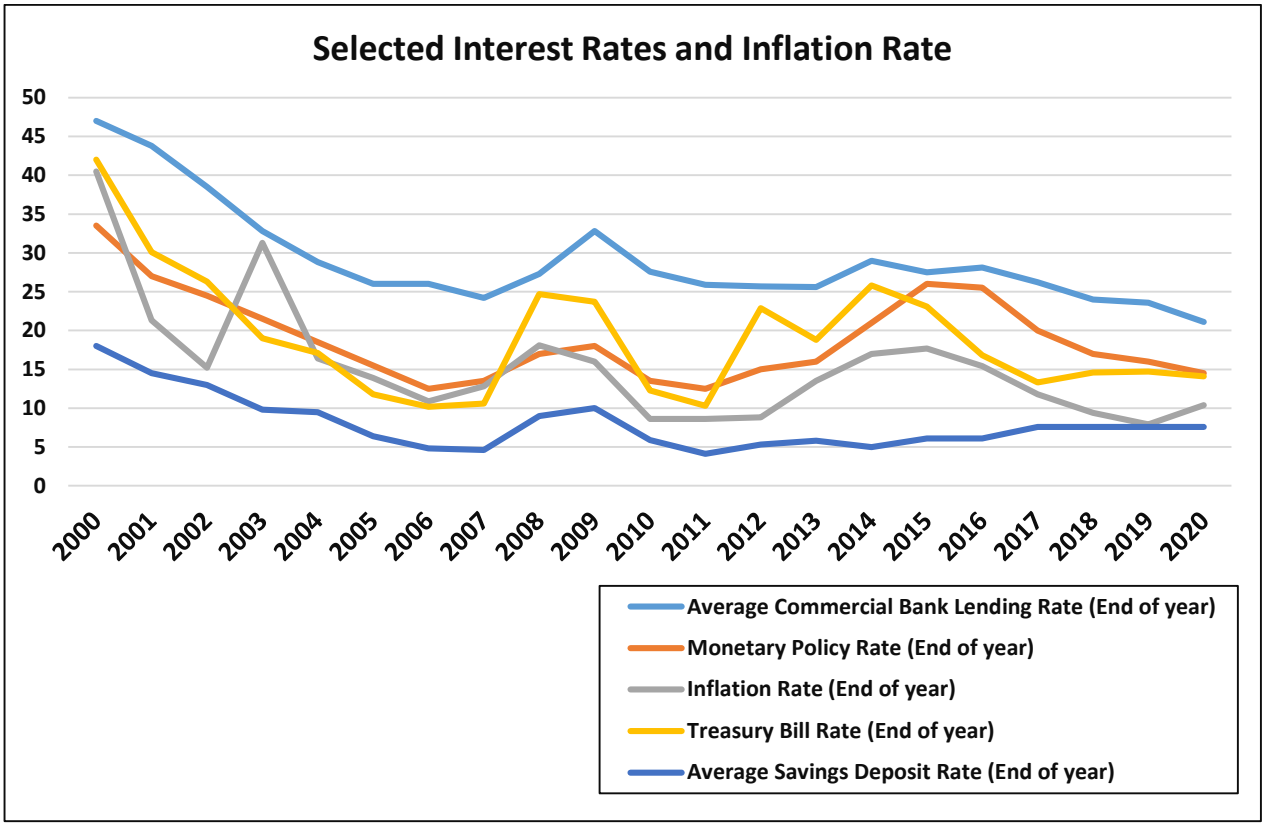
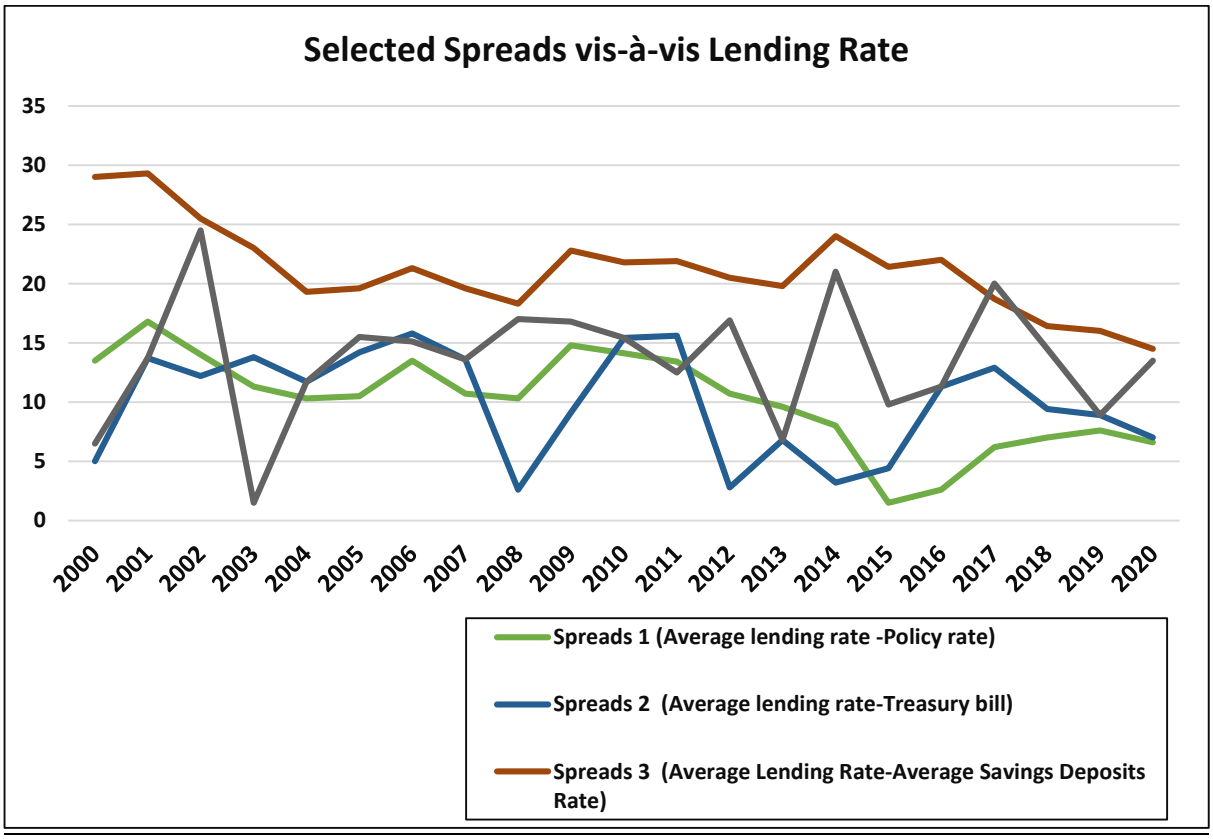


Fig. 7: Selected Spreads vis-à-vis Lending Rate



In fact, all these measures—levels and spreads—are telling us the same story, viz. that the lending rate is out of place—an anomaly that needs to be fixed.

2. THE CAUSES OF THE HIGH LENDING RATE

This brings us to the reasons behind high lending rates.

We have extensively researched the problem of high lending rates. I personally have been involved with monetary policy for a long time as a staff of Bank of Ghana and as a member of the Monetary Policy Committee. From the evidence available to us, we can say that the causes of high lending rates are multifaceted. You cannot pin it down to just one cause—or even two. We can also say that the causes may be placed at the doorsteps of three key actors in the economy: banks, government and the monetary and regulatory authority. It is good for the President to draw attention to it and charge the monetary and regulatory authority, in its capacity as the institution responsible for monetary policy and as the overseer of the entire financial sector to spearhead the resolution of the problem. However, being jointly responsible for the problem, banks, Government and the monetary and regulatory authority—as we demonstrate below—these actors have a collective responsibility for fixing it.

The Role of Banks

Let us start with banks.
To achieve their target profits, banks must manage both their income and costs. The bulk of banks' income comes from interest income. It is logical, therefore, that banks will endeavour to keep their lending rates as high as possible so as to maximise their income and profits—for given costs. But the question is whether lending rates maintained by banks are justified by the banks' costs. Before we provide a definite answer to this question, let us first take a look at the kind of costs banks incur and which play a key role in the determination of their lending rates.

Like other businesses, banks' costs come from a variety of sources. Bank costs emanate from structural inefficiencies, operating and overhead costs and costs associated with loan defaults, fiscal policy and monetary policy. Like other businesses, banks face structural inefficiencies related to a variety of factors such as: deficient processes and systems, paper overload, lack of strategic focus or planning, unnecessary location dependency or display of spatial opulence, staff delinquencies, marathon meetings, etc. These inefficiencies increase costs. In their operations, banks incur operating and overhead costs, including relating to labour, materials, equipment, rent, utilities and insurance. Loan defaults represent obvious costs to banks. Loan defaults emanate from poor appraisal of customer projects and lack of adequate identification system for borrowers, among other factors. High and multiple taxes add significantly to banks' costs. Monetary policy imposes costs on banks. The unremunerated 8% primary reserve requirement represents a cost to banks. The rule that requires banks to keep reserves against dollar deposits in *cedis* further imposes exchange cost on banks.

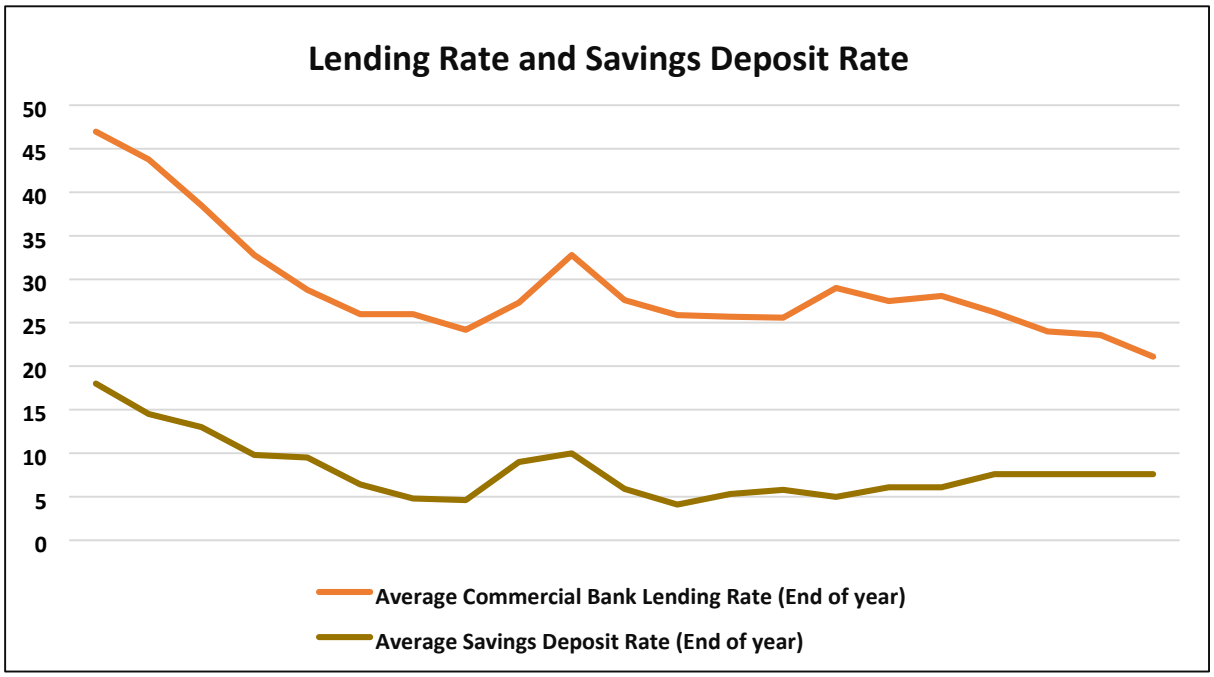
We have conducted a survey of banks on their costs and how they affect their lending rates. As expected, the banks confirmed that their costs drive their lending rates. We have not attempted to quantify the relative magnitudes of these costs, but one can do that through analysis of banks' financial statements. During the survey, I recall the banks indicating that staff costs, other administrative costs, materials costs, taxes and utilities costs were relatively high. Indeed, Bank

of Ghana recognises the importance of these costs. The Bank was particularly concerned with the level of staff costs that it decided to impose ceilings on banks' executive pay during the financial sector reform in 2018. Further, Bank of Ghana factored banks' costs into its determination, initially, of Base Rates for individual banks and, ultimately, of the Ghana Reference Rate (GRR), both of which are intended to serve as benchmarks for banks' lending rates. Factoring bank costs into the determination of benchmark lending rates for banks, however, appear to be validating these costs instead of scrutinising their legitimacy. In any case, the use of these mechanisms to "regulate" banks' lending rates have had limited success, and that is why we are still talking about high lending rates today.

The question is whether these costs justify the high lending rates and spreads of banks. We do not think so. This is because the banks' yearly financial statements indicate that they make adequate profit. Bank of Ghana's financial assessments confirm the high profitability of the banking industry along with other strong Financial Stability Indicators (FSIs).

The Ghanaian banking system is known to lack vigorous competition. The number of banks was deliberately increased by the authorities over the years, with the hope that competition will naturally follow. But anybody familiar with the banking system will attest to the fact that it remains a highly concentrated, collusive system, lacking competitive product pricing and having a tendency to copy themselves in setting interest rates and other financial charges. Meanwhile, there is a clear evidence of "customer capture," with banks able to keep their customers no matter how uncompetitive their product pricing is. These features of the industry manifest in elevated lending rates, depressed deposit rates, and large spreads (Fig 8).

Fig 8: Lending Rate and Savings Deposit Rate



The spread between the lending rate and savings deposit rate has averaged as high as 20 percentage points over the period. This spread is a key determinant of banks' profitability; it is

indeed an indicator of a bank's profit margin. The large spread is evident of the peculiar characteristics of the industry described above. In normal banking systems, this spread will not exceed 5 percentage points.

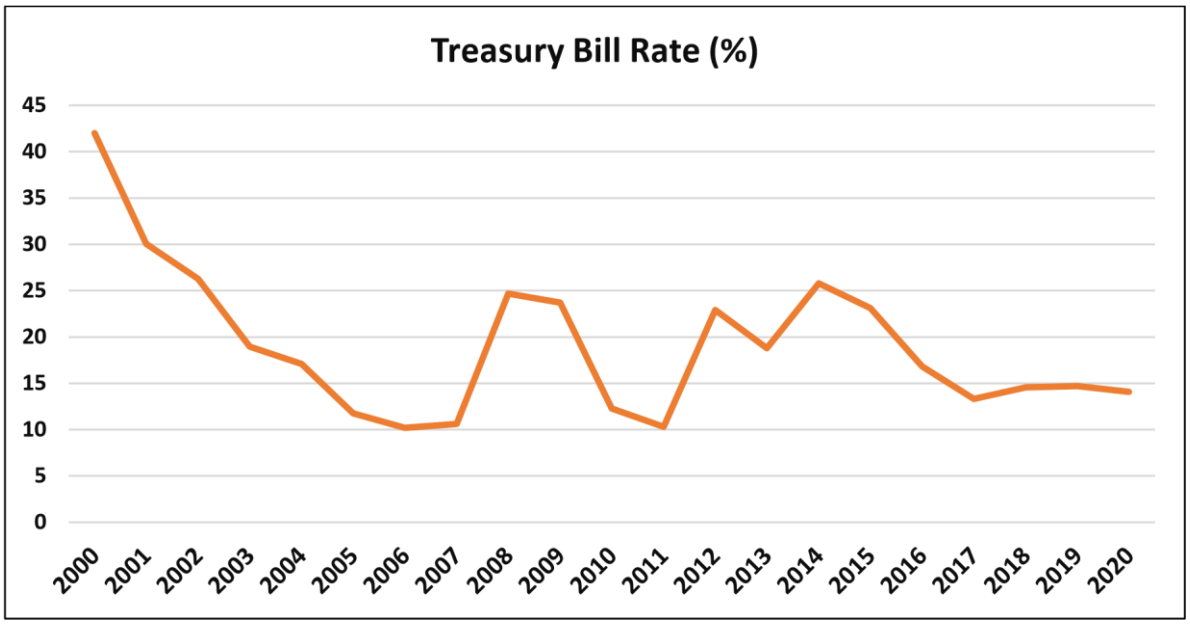
We wish to point out that high lending rates is not the only problem in the banking industry. There exists a plethora of equally-high charges associated with loans or other financial services that customers have to deal with but which do not attract enough attention. These include, in connection with loans, arrangement fees, processing fees, commitment fees, facility fees and insurance fees. If I have duplicated some of these fees, the bankers should please forgive me. They can better classify them. Equally high are charges levied for other financial services such as the use of credit cards, use of ATMs and foreign exchange transactions. In most cases, the fees and charges are prohibitively high and difficult to justify. They are allowed to fester in a totally unregulated financial system, which is not the case in many other jurisdictions. This is an issue that I will come back to later.

The Role of Government

Let us turn to government's role in the high lending rates syndrome.

Government is a contributor to high lending rates. It is important that this is recognised so that government becomes part of the solution. The first channel through which government affects the lending rate is its borrowing from banks to finance the budget. We know that fiscal deficits have been generally high in Ghana and government has relied heavily on banks to finance them. By competing with the private sector for loanable funds, government borrowing fuels lending rates.

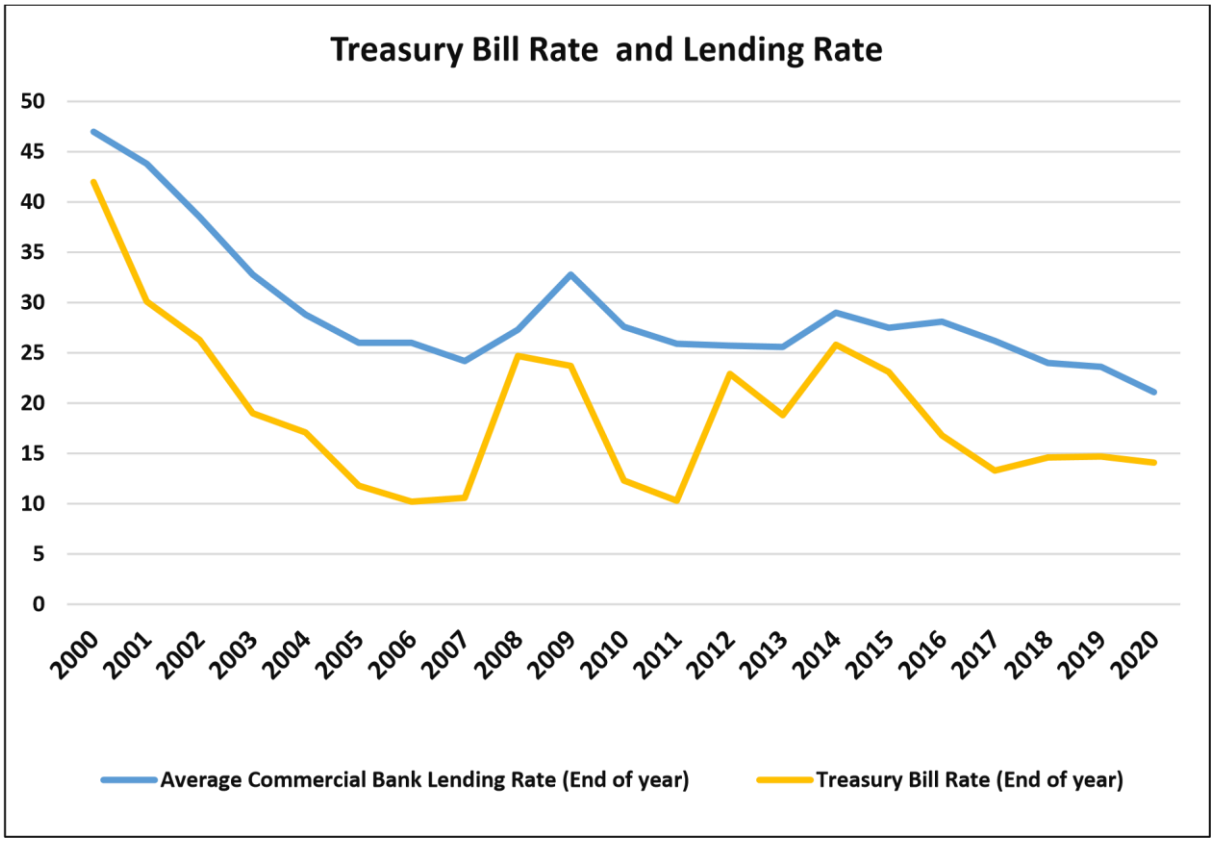
Fig 9: Treasury Bill Rate



On its own, the Treasury Bill rate, which government pays for borrowing from banks averaged about 17% yearly during 2000-2020. Let us recall briefly from Fig 1 that the lending rate, which

banks charge private customers, averaged 27% yearly during the period. It is understandable why banks lend to government at lower rates than they do to the private sector. This is because government debt is almost risk-free, whereas private sector debt carries considerable risk. In spite of this fact, however, government borrowing from banks has not come cheap.

Fig 10: Treasury Bill Rate and Lending Rate



While the Policy Rate may be the primary benchmark for banks' lending rates, the banks also use the Treasury Bill rate as, somewhat, a secondary benchmark. Figure 10 shows that the spread between the lending rate and Treasury Bill rate averaged as high as 10 percentage points yearly during the period. It may not be a coincidence that we reported the same average spread between the lending rate and Policy Rate (Fig 2).

Evidence shows that the Ghana has experienced macroeconomic instability, of which high fiscal deficits have been a contributory factor. High interest rates generally tend to be a feature or symptom of macroeconomic instability. Therefore, high deficits may affect lending rates directly through the borrowing from banks to finance them and indirectly through the macroeconomic instability that they generate.

Another channel through which government policy influences lending rates is taxes. Banks have faced high and multiple taxes over the years. Our understanding is that corporate tax for banks listed on the Ghana Stock Exchange is 37.5% and 40.0% for unlisted banks. In addition, banks also currently pay 5% Fiscal Stabilisation Levy and 5% Financial Sector Bailout Levy. Ministry

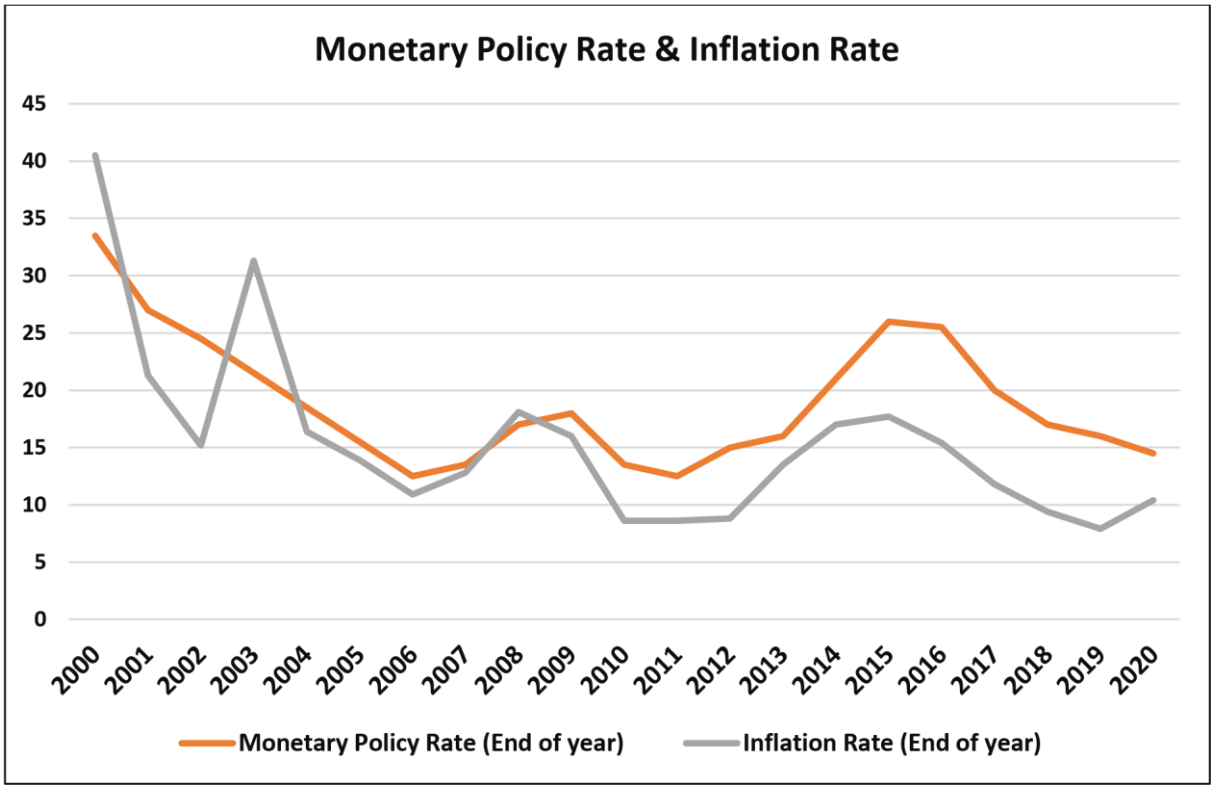
of Finance staff present may please correct me if I am wrong. These taxes, of course, increase bank costs and fuel their lending rates.

The Role of the Monetary and Regulatory Authority

The monetary and regulatory authority (MARA) is the third key influencer of banks' lending rates. Again, it is important to recognise the contribution of the authority so that it may be roped appropriately into the search for solutions.

Monetary policy affects interest rates generally. The Monetary Policy Rate (MPR) is the overall benchmark for other interest rates. The Central Bank manages the MPR in response to inflation signals. The MPR is normally raised in response to inflation risk—and vice versa. The Central Bank lends to banks at the MPR—plus a margin. A change in the MPR is a signal to banks to adjust their lending rate in line.

Fig 11: Monetary Policy Rate and Inflation Rate

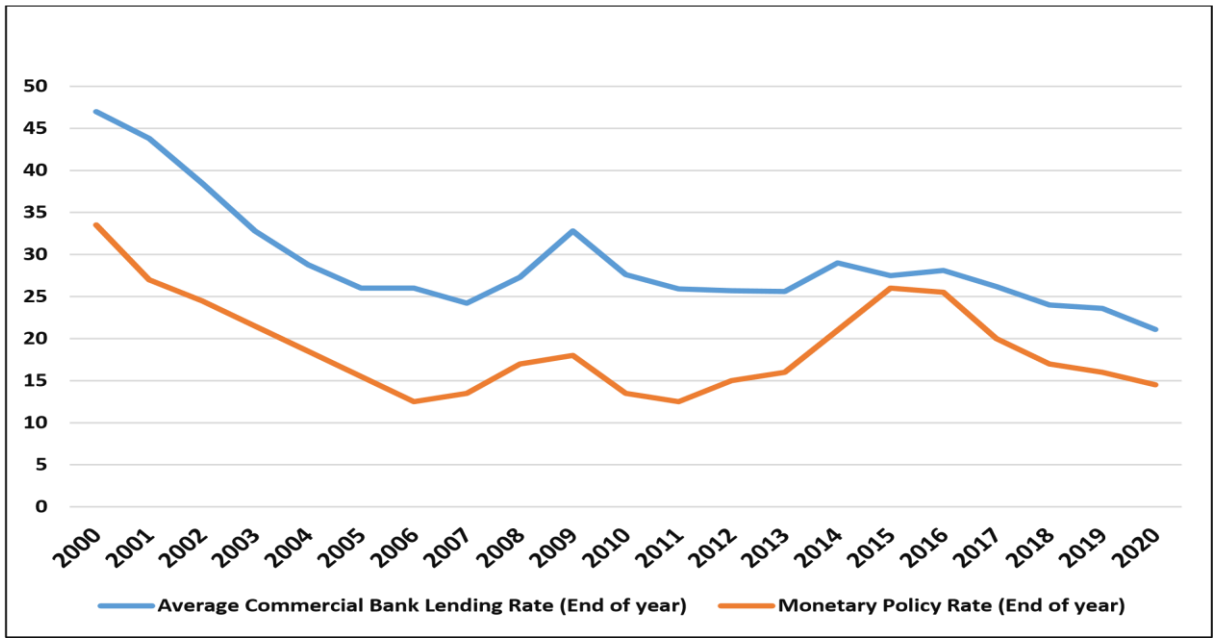


Ghana has had a long history of inflation. During 2000-2020, inflation averaged about 15% yearly (Fig 11). In response to the persistent inflation, the monetary authority has had to maintain an equally high MPR. The MPR averaged about 18.5% yearly during 2000-2020.

Because the MPR has been maintained at fairly high levels in the attempt to control inflation, and to the extent that the lending rate adjusts somewhat in line with the MPR, the MPR has fuelled the high lending rate. Historically, whenever the MPR was increased in response to rising inflation, lending rates tended to follow quickly. However, when the MPR was reduced in

response to declining inflation, lending rates followed less quickly. The response of the lending rate to the MPR has, therefore been asymmetrically biased upwards. To that extent, the MPR can be said to have contributed to the sustenance of high lending rates.

Fig 12: Monetary Policy Rate and Lending Rate



The spread between the LR and MPR has generally narrowed during 2000-2020 from about 13 to 7 percentage points. A reasonable margin, however, is about 2-3 percentage points. This means that, there is room for the existing spread between the LR rate and MPR to narrow further. The Central Bank lends to banks at the MPR plus a margin of about 2 percentage points. This places the ideal spread between the LR and MPR at about 4-5 percentage points.

As we noted above, reserve requirements constitute a cost to banks. The primary reserve ratio of 8%, which is unremunerated, and the rule that requires banks to keep reserves against dollar deposits in *cedis*, both represent costs that contribute to the high lending rates. The primary reserve requirement serves both a monetary policy purpose and a prudential purpose. As a monetary policy tool, it is meant to control banks' capacity to create credit and, eventually, money. As a prudential tool, it serves as partial insurance for customer deposits. However, under an Inflation Targeting (IT) framework, money supply is not directly targeted and, therefore, the primary reserve ratio is irrelevant for monetary policy. It may, however, be needed as a prudential tool especially in the absence of effective Deposit Insurance Schemes. It is the level, therefore, that is in question rather than its overall legitimacy.

Credit Reference Bureaux are supposed to maintain information on customer credit records and make same available to banks to assist them in assessing borrowers' credit worthiness. However, it is unclear how effectively the existing Bureaux have been functioning. In the context of inadequate information about borrowers generally, credit risk remains high and fuels lending rates.

3. RECOMMENDATIONS

Given that banks, government and the monetary and regulatory authority are jointly responsible for the problem of high lending rates, what do we want them to do to address the problem on a lasting basis?

Banks

1. Banks should address their operational inefficiencies to reduce their costs so that they are not passed on to customers. They should improve their working processes and systems through modernisation and digitisation, among others. In general, banks should reduce their paper overload, economise on time, void unnecessary location dependency practices, reduce incidence of staff delinquencies, and have a strategic company focus and foresight planning about improving their efficiency.

2. Banks should reduce their operating and overhead expenses. They should contain their labour costs by keeping the right size of staff and reasonable levels of staff pay. Banks should keep material, equipment and rent expenses under control and economise on the use of utilities.

3. Banks should strengthen their capacity for appraising customer projects so as to reduce incidence of loan defaults and the effect on their costs.

Government

1. Government should restrain borrowing from banks by keeping the budget deficit under control so as to reduce competition for loanable funds and create the necessary stable macroeconomic environment to ease pressure on lending rates.

2. Government should streamline banks' taxes to help reduce their costs. In particular, banks should have the same level playing field as other companies in terms of corporate tax rate. From that standpoint, the 5% Ghana Fiscal Stabilization Levy imposed on banks since 2001, would seem hard to justify and may have outlived its usefulness, if any. The point is that banks should not be given the opportunity to use their higher taxes as an excuse for their high lending rates. If banks have a level playing field in terms of taxes and they still make "super profits," government may impose special time-bound levies on them cloaked as their contribution to the development of the economy—just as any other booming part of the economy.

3. Government should streamline banks' taxes to help reduce their costs. Banks' corporate tax should be set at reasonable level. Government should consider scrapping the 5% Ghana Fiscal Stabilization Levy that has been in place since 2001 because it is hard to justify and has outlived its usefulness, if any.

4. Together with the monetary and regulatory authority, Government should promote and support parallel or specialised financial institutions such as rural banks, the newly-

established National Development Bank, etc. to offer accessible funding especially to SMEs and strategic sectors of the economy, such as agriculture, industry and housing, in order to reduce the demand for loans from the traditional banks and help ease pressure on lending rates.

Monetary and Regulatory Authority

1. The monetary and regulatory authority (MARA) should ensure that the fight against inflation does not itself fuel lending rates. This requires a broader approach to fighting inflation, including by paying attention to some of the supply-side causes, rather than adhering strictly to the management of demand pressures.

2. The MARA should reduce the primary reserve ratio from the current level of 8% to 5% to reduce the associated cost to banks. Further, MARA should allow banks to cover their dollar deposits with dollar reserves to avoid their exposure to exchange risk and its passage on to lending rates.

3. MARA should ensure that the Deposit Insurance Scheme works effectively so as to make a high primary reserve requirement for prudential purposes unnecessary.

4. MARA should ensure that Credit Reference Bureaux operate effectively to help reduce borrower risks, incidence of loan defaults and lending rates.

5. The MARA should keep bank customers continually informed about interest rates and other charges and fees in the financial sector so that they can make informed decisions in accessing financial services. This will force the hand of banks to offer competitive prices for their products. The current practice whereby the MARA publishes banks' lending rates is a step in the right direction and its reach should be extended.

6. As the most significant—and potentially most effective—intervention, the MARA should "regulate" the spread between the LR and MPR. This will force the hand of banks to follow the MPR more closely and to keep the lending rate within bounds.

   As a first scenario—and possibly the more manageable one—the MARA should impose a ceiling of 5 percentage points on the spread. As a second scenario, the MARA should introduce a rule whereby the spread maintained by any bank will be equated with the primary reserve ratio of the bank. In other words, if a bank maintains a spread of 5 percentage points in the previous month, its primary reserve ratio for the ensuing month will be 5%. If it maintains a spread of 10 percentage points, its primary reserve ratio will be 10%. This rule will be an incentive for banks to keep the spread to a minimum. A frequently-changing reserve requirement may, however, present implementation challenges, so we leave it to the MARA to figure out the best way to operationalise it.

   Putting banks on such a tight leash will render monetary policy delivered via the MPR more readily transmissible and more effective. These measures will be temporary and could be changed as needed. They should not be seen as "controlling" lending rates in the strict sense of the word, a regime that nobody wants to revisit. It will only amount to

"regulating" lending rates. Banks are still very profitable with the current spread of 7 percentage points. Therefore, shading off a few percentage points is not going to send the banks into huge losses. In any case, this will force banks to undertake the measures prescribed above to reduce their costs, increase their efficiency and increase their profitability. It has to be said that this will also not be the only regulatory rule in financial transactions. We know that when banks buy foreign exchange from the MARA, they can sell it to their customers only within a prescribed margin. Therefore, imposing a similar margin between the rate at which banks borrow from the MARA (i.e. the MPR) and the rate at which they sell funds to the public (i.e. the LR) will not be significantly different.

We have heard it said that if you regulate banks' lending rates they will refuse to lend. We beg to differ. If Government reduces its borrowing from banks by reducing the budget deficit, as we have recommended above, banks will have no option but to lend to the private sector since they cannot afford to sit on idle funds. It has also been argued that banks would likely depress deposit rates to maintain existing spreads. To limit this potentially undesirable outcome, as we have recommended above, depositors should be empowered by providing them with adequate information so that they can protest with their feet by shopping around for the best deposit rates. Otherwise, I would be minded to suggest that a ceiling of 10 percentage points should also be imposed on the spread between the lending rate and the deposit rates.

We want to repeat that the suggestion for regulation of the lending rate is only meant to be a temporary measure that will be monitored by the MARA and changed whenever it finds it necessary to do so.

7. The MARA should regulate other financial charges and fees, including those levied in respect of related to loans, use of credit cards, use of ATMs and foreign exchange transactions. This is to help moderate charges for financial services generally. Financial services, like other financial services and goods that are used on a universal scale, such water, electricity, public transport, postal services, are regulated in most countries, since if left to the market, providers could exploit the large numbers of consumers involved and make huge abnormal profits.

8. Together with government, the MARA should promoter and support parallel or specialised financial institutions such as rural banks, the newly-established National Development Bank, etc. to offer affordable funding especially to SMEs and strategic sectors of the economy such as agriculture, industry and housing, in order to reduce the demand for loans from the traditional banks and pressure on lending rates

It has to be emphasised that it is not only a concerted strategy but also an interventionist approach may be required to address the long-standing problem of high interest rates. It should be the joint responsibility of banks, government and the monetary and regulatory authority to achieve the desired outcome. We, however, see the responsibilities of banks and government to be largely voluntary, which means that they cannot be fully relied upon. Therefore, to us, the ultimate responsibility seems to lie with the monetary and regulatory authority. In that regard, we have to say that, to be successful, we should go beyond the orthodox, moral suasion and free market-based approach, and adopt a more interventionist approach. This is because the problem of high lending rates represents a typical market-failure in the financial sector, which requires a

"visible hand" to correct. In any case, the proposed regulatory interventions are meant to be applied on a pilot basis to see how they work out. Should they be seen to be ineffective or counterproductive, they can be reformed accordingly. But not acting is not an option!

APPENDIX

DATA

YEAR	Average Commercial Bank Lending Rate (End of year)	Monetary Policy Rate (End of year)	Inflation Rate (End of year)	Treasury Bill Rate (End of year)	Average Savings Deposit Rate (End of year)
2000	47.0	33.5	40.5	42.0	18.0
2001	43.8	27.0	21.3	30.1	14.5
2002	38.5	24.5	15.2	26.3	13.0
2003	32.8	21.5	31.3	19.0	9.8
2004	28.8	18.5	16.4	17.1	9.5
2005	26.0	15.5	13.9	11.8	6.4
2006	26.0	12.5	10.9	10.2	4.8
2007	24.2	13.5	12.8	10.6	4.6
2008	27.3	17.0	18.1	24.7	9.0
2009	32.8	18.0	16.0	23.7	10.0
2010	27.6	13.5	8.6	12.3	5.9
2011	25.9	12.5	8.6	10.3	4.1
2012	25.7	15.0	8.8	22.9	5.3
2013	25.6	16.0	13.5	18.8	5.8
2014	29.0	21.0	17.0	25.8	5.0
2015	27.5	26.0	17.7	23.1	6.1
2016	28.1	25.5	15.4	16.8	6.1
2017	26.2	20.0	11.8	13.3	7.6
2018	24.0	17.0	9.4	14.6	7.6
2019	23.6	16.0	7.9	14.7	7.6
2020	21.1	14.5	10.4	14.1	7.6
Average	29.1	18.9	15.5	19.2	8.0

Source: Data from Bank of Ghana