

Consequences of Host Country Threshold Regimes on Small Businesses

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This theoretical paper discusses the possible consequences of the impending Bank of Ghana policy of compelling universal banks operating in Ghana to re-capitalize from the present GH¢7 million to GH¢ 60 million by the end of 2012. The paper assesses the implementation of similar policies in different parts of the world and concludes that in most of the economies where the consolidation has taken place, the positive intentions of the Central banks have emerged intact but SMEs do not get the best of deals. The paper concludes that the Ghanaian situation is not going to be different and is likely make Ghanaian SMEs worse off than they are enjoying now.

INTRODUCTION

The effect of deregulation of domestic financial markets has been an important policy issue for developing countries for some time (Levine, 1997). In the last decade, many developing countries in Asia, South America and Africa have gradually deregulated their financial markets. The relationships between financial market liberalization and economic development have been extensively explored; the results indicate that liberalization of financial systems is a major factor in economic development, but needs to be carefully sequenced and managed (Caprio and Summers, 1996, Levine, 1997). As a result, many developing and emerging economies that used to protect their markets have embarked on a number of financial sector development programs since the mid-1980 in order to revamp their economies. Ghana is one of such developing economies that embarked on a financial sector adjustment programme since 1983. The banking sector in Ghana before the Financial Sector Adjustment Programme (FINSAP) comprised of six state-owned banks and two multinational banks from the United Kingdom.

The impact of the FINSAP was felt in the early 1990s when there was marginal growth in the number of private local banks in Ghana, but a more robust growth was recorded at the end of 2007. Ghanaian financial sector according to the Bank of Ghana (BoG) is well capitalized, very liquid, profitable and recording strong asset growth. The Ghanaian banking sector has seen major capital injection partly because of the political stability, attainment of micro and macroeconomic stability and the desire to make Ghana the financial hub of the Sub-region. The Central bank has promoted the enforcement of statutory requirements, more stringent supervision and increasing capital requirements. As at December, 2008, the Bank of Ghana had licensed twenty six (26) universal (commercial, development, and merchant) banks to operate in the country. Among the recent entrants into the banking arena of Ghana are six banks from Nigeria, one from Libya and one from South Africa. It is believed that the internationalization of these banks have brought a major revolution in the Ghanaian banking environment. A distinguishing feature of the sector is the level of ownership by the private sector, directly or through the capital market, when compared with the level of state ownership seen in the financial sector in other African countries; state-owned banks have been reduced to three now.

Banks compete with each other in gathering individual savings and in loaning funds to entrepreneurs. Obviously, competition is rife in the Ghanaian banking sector and the new banks are trying to revolutionize access to banking services which was denied the population by the imperialist banks years ago. Several banks have already made determined efforts to roll out the use of internet banking, smartcard technology, mobile phone banking and the use of biometric technology to cover all their operational areas. Above all, loan processing has reduced from months to as low as 48 hours.

In June 2008, the Central Bank of Ghana issued a policy that is to set the minimum capital of universal banks from the present GH¢ 7 million to GH¢ 60 million by the end of 2009. However, banks with significant Ghanaian ownership (local banks) have been given up to the end of 2010 to increase their stated capital to GH¢ 25 million and finally GH¢ 60 million by the end of 2012.

This theoretical paper discusses the consequences of the Bank of Ghana's directive on local Small and Medium Enterprises (SMEs). Thus, the paper proposes that the opposite effect of bank concentration is bank consolidation (Cetorelli and Peretto, 2000). Since concentration theories have linked bank consolidation to reduction in credit supply (Berger et al, 1995) to SMEs (Peek and Rosengren, 1996); the ministry of Finance and Economic Planning and the Bank of Ghana owe Ghanaians a duty to ensure this does not happen.

The discussion points out the likely negative effects the consolidation is likely to have on SMEs in Ghana and presents practical recommendations to the Bank of Ghana. Even though most propositions are likely to be speculative, lessons will be drawn from the extant literature and other jurisdictions to support such assertions.

THEORETICAL FRAMEWORK AND LITERATURE

Financial sector development is often hindered by government-imposed restrictions and price distortions on the financial sector, which are mainly applied so that the government can use the financial system as a source of public finance. In developing countries, examples of these policies include high inflation taxation, high required reserves ratios, subsidized or directed credit, collusive contracts between public enterprises and banks, credit rationing, and ceilings on deposit and loan interest rates (Fry, 1995, Beim and Calomiris, 2001). Acemoglu and Johnson (2005) posit that expropriation is the greatest threat to FDIs. Experts conjecture that political institutions that are protected from expropriation are necessary for liberalized financial sectors to work properly for two reasons. First, with a high risk for expropriation by the state, economically viable investors and projects may not generate profits to honour loan repayments. Thus, even if banks are efficient and liquid, there may not be profitable projects to finance from the viewpoint of banks. Second, in such countries, banks themselves may be threatened by expropriation or political interference in their lending decisions, even though the financial system is fashioned along liberalization. As a result, banks may lend only to the government or politically-connected groups within the economy. Over time, innovations in financial instruments, telecommunication, information technology, organization innovation and the growing sophistication of customers have meant a dramatic transformation in the conduct of banking business and client relationships in international banking.

The literature has long stressed that one of banks' crucial roles is to produce information about entrepreneurs in order to evaluate their credit worthiness (Ramakrishnan and Thakor) However, there is cost incentive associated with information production (Campbell and Cracaw). They discuss how the market powers of banks affects their incentives to spend on information production, given that the information they produce is not fully appropriable. Craig and Houston (2004) found out that small businesses receive less credit on average in regions with a large share of deposits held by the largest banks, irrespective of how debt is measured.

Cetorelli and Peretto, (2000) postulate that the fewer the number of banks, the smaller the total quantity of credit available to entrepreneurs. On the other hand, the fewer the number of banks, the higher the incentive to produce information, and therefore the larger the proportion of funds allocated to screened, high quality entrepreneurs. Therefore, the number of banks governs a trade-off between the overall size of the credit market and its efficiency.

The number of banks affects capital accumulation through two channels. First, it affects the quantity of credit available to entrepreneurs. Second, it affects banks' decisions to collect costly information about entrepreneurs, and thus determines the efficiency of the credit market (Cetorelli and Peretto). According to the authors, under plausible conditions, the market structure that maximizes the economy's steady-state income per capita is neither a monopoly nor competition, but an intermediate oligopoly. Moreover, the credit market splits in two segments: one in which loans are screened and only high quality entrepreneurs obtain credit, and one in which banks extend credit indiscriminately to all entrepreneurs. The relative size of the two segments depends on the market power of banks and evolves endogenously along the path of capital accumulation.

As regards the international banking firm, Gray and Gray (1981), Yannapoulos (1983), Sagari (1992) and Williams (1997) make use of the standard eclectic paradigm of FDI— originally developed by Dunning (1977, 1981)—to explain the internationalization of banks on the basis of location-specific, ownership-specific and internationalization advantages. Similarly, Buch and Lipponer (2004) directly apply a framework for non-financial firm's FDI to banks' internationalization strategies. According to Hawkins and Mihaljek (2001), establishing an affiliate relationship or participating in a joint venture can be another way to engage in foreign expansion. This usually involves taking minority stakes in local entities, and the level of involvement in the management of the local banks by the foreign bank is normally low.

EFFECT OF CONSOLIDATION ON SMES

Threshold Regimes

Malaysia consolidated its banking sector whereby about 80 banks shrunk to about 12 within one year. In Malaysia, banks were required to raise their capital base from about \$70 million to \$546 million in one year. In Singapore (with about three million people), banks have now consolidated to about four – with the second largest bank having a capital base of about US\$67 billion. Consolidation took place in South Africa in 2003. A similar exercise took place in the United States in the Mid-1980s.

Arguably, the policy to increase capitalization is not peculiar to Ghana alone; Within ECOWAS, Nigeria executed this directive with absolute rigidity by giving commercial banks 18 months to comply with this obnoxious directive. In July, 2004, the Central Bank of Nigeria (CBN) issued the directive increasing the minimum stated capital from N2billion to N25 billion by the end of 2005. Ghana is the only country that set a discriminatory roadmap to the effect that foreign banks have been given shorter deadlines than local banks. This underscores the assertion that in highly competitive environments, regulatory policy actions are rolled out in the effort to favour local players though subtly. Other countries such as Liberia and Gambia discriminated between new entrants and existing operators. Table 1 below depicts the ongoing practice of re-capitalization directives by national central banks in Anglophone West Africa.

Table 1: Threshold of Minimum Stated Capital of Banks in Anglophone West Africa

Country	Existing capital	Proposed (new) capital	Deadline	Remarks
Nigeria	N 2 Billion (\$16 Million)	N 25 Billion (\$ 190 Million)	31/12/2005	Completed
Ghana	Gh¢ 7 Million (\$ 7 Million)	Gh¢ 60 Mllion (\$ 60 Million)	31/12/2012	Stages
Liberia	\$ 6 Million	\$ 10 Million	31/12/2010	Stages
Gambia	D 60 Million (\$ 3 Million)	D 200 Million (\$ 10 Million)	31/12/2012	Stages

It is touted that increase in capitalization will bring about; minimal risk of distress; economies of scale; capacity of banks to be able to fund bigger and viable projects; curb the rampant request for licenses; lead to innovations and diversification of banking products; effectively provide banking services to customers and mobilize funds from the public; and provide banking at low cost, among others.

Indiscriminate Acquisitions

The positive arguments behind these policies notwithstanding, the consequences can be devastating. The first danger the researchers foresee is that the directive is likely to lead to mergers, acquisitions and takeovers within the banking sector in Ghana, since most of the banks cannot meet this minimum requirement. If the Nigerian example is anything to go by, we can pick a few lessons from there; prior to 2005, Nigeria had 89 universal banks operating in the country, after the compliance, they were reduced to 25 banks emerged out of 75 banks through mergers, acquisitions and takeovers. 14 banks had their licenses revoked. One can deduce that the Ghanaian situation is similarly an unbalanced one; there are the solvent foreign banks and the fragile and marginal local banks. Mergers may not be the solution when firms are unequal in their bargain, the possible picture will be takeovers and acquisitions. The ramifications of these could be somewhat 'hostile' and could have psychological consequences on the employees of underdog firms. Even where two companies merge, the post-merger challenges can rage on for years, how much more multiple companies with different cultures and orientations.

Furthermore, Ghana has no clear-cut mergers and acquisitions legal framework to undertake such large scale acquisitions, neither are there skilled negotiators for the purpose. With this exercise, the floodgates will be opened for the giants in the industry who possess greater bargaining power to engage in cheap and fraudulent acquisition of underdog banks. For instance, part of the arguments that led to the inability of Stanbic Bank to acquire Agricultural Development Bank (ADB) in 2007, was that, ADB was specifically established to provide credit to farmers; but Stanbic has no such record of financing farmers even in South Africa.

With the new arrangement, Stanbic stands the chance of acquiring ADB and other local banks without any conditions. In fact, this time around, ADB is likely to be more submissive and proactive in the process. Eventually, credit to the farmers and other local SMEs will still be non-existent.

I proceed with the assumption that out of the 26 banks in Ghana, only about half may survive. One can also conclude that majority of those that will survive are likely to be foreign banks. This argument is not far-fetched because there are about five Nigerian banks operating in Ghana whose parent banks have passed the litmus test in Nigeria; there is also Stanbic bank from South Africa that made the attempt to acquire a state-owned bank though unsuccessful as a result of public pressure, there are also the two multinational giants- Barclays and Standard Chartered Banks of Ghana and finally, Ecobank, the sub-regional bank. How can a nation put its developmental interests in the hands of foreigners?

Fewer Banks and Focus Strategy

Drawing from the current directive; foreign banks must comply by the end of 2009. This approach, while looking like offering local banks more time to raise capital, the waiting time will presumably offer the smaller local banks the opportunity to start discussions with those who have already crossed the threshold. The eventual consequence is that most of the banks that will survive will be foreign-owned and few public-listed local ones. The major worry is that, who determines the strategic plans of foreign banks? Ghana has emerged from a banking situation where multinational banks only took deposits higher than the average salary of public service employees. Once banks get the nod in a less concentrated environment, strategies towards the market will change. The competitive environment that made marketing pivotal in their operations will be no more. At this stage banks SMEs are likely to suffer these hardships because it is expensive to manage SME portfolios as compared to large companies. Obviously, it is corporate banking that will get the necessary support. Corporate banking has less risk in that their structures are identifiable, historical evidence are available, and collateral issues are reliable.

Cost of Banking

Contrary to the characteristic of oligopolies as highly competitive, bank consolidation brings about elimination of competition. Competition is what often aids in keeping cost at a reasonable rate. In

addition, service is often a major factor where competition is involved, as each individual entity strives to win consumer favour. With the reduction in banks, switching costs become high, customers are usually stuck with one financial institution; and that institution has no reason to keep cost low for its customers. This can bring about exorbitant prices on customers who have no choice but to pay what is asked or go without. Evidence from the United States suggests that large banks charge higher fees and pay less interest on deposits. They also make fewer loans available to small businesses than the small banks they take over from (Dymski, 1999). Large banks are characterized by bureaucracy and arrogance. Access to Managers can be very problematic since they look down upon small customers. Another factor that brings about high cost of fees in large banks is that those in governance positions live like 'kings' and run the companies like empires. The cost of extravagant lifestyles and high cost of promotions are shifted to the customer. In recent cases, directors of large banks in United States of America have been exposed as running down their banks as a result of extravagant lifestyles and high bonuses they allot to themselves at the expense of customers and shareholders.

Oligopolies

SMEs in Ghana cannot be compared to SMEs in the western world. UNIDO recognizes that there are differences in SMEs from developing countries. What may be considered a large company in Ghana may be small in Germany or the U.K., the fact that SMEs elsewhere got adequate attention after bank consolidation does not necessarily mean it will also work in Ghana. One important consequence of this directive is the fear of oligopolies which will in turn affect SMEs and individual clients. An oligopoly is an industry composed of a limited number of large firms (Hill, 2005). The reduction in the banks is likely to take Ghana back to the previous situation when banks will rationalize each move they made because they knew what competitors were doing or likely to do. Concentration of banks in the economy is therefore in the interest of SMEs and retail customers. This is because; it is difficult for banks to monitor what competitors are doing in the short-run. The speculation that competitors are way ahead on the market brings value to the customer. Also, when firms are equal in size, they tend to have a common platform discuss opportunities that will strengthen their position in the market at the expense of customers.

Access to Banking Services

The re-capitalization policy of the bank of Ghana does not ensure national presence of banks. In Nigeria, the condition precedent for a foreign bank to acquire a local bank is that, the foreign bank must have operated in the country for at least 5 years and must have branches in at least 24 out of the 36 states in the country. In Ghana, apart from Ghana Commercial Bank that has the national presence (135 branches countrywide), the rest operate within the regional capitals and few commercial district capitals. The foreign banks are mostly guilty of this and there is the possibility that most of these foreign banks will close down some of the branches of acquired banks that are in low profit locations. Closing down branches as was seen in the 1980s will bring about the concomitant lack of access to regular banking services by the small businesses in the hinterland. Eventually, the danger of massive unemployment in the banking industry looms.

RECOMMENDATIONS

The paper proposes that the Bank of Ghana rolls out detailed implementation guidelines to facilitate the impending exercise. It is also recommended that the Bank of Ghana issues further guidelines compelling Banks to open offices in at least every region of Ghana so as to satisfy the national presence. The seemingly concentration of large banks in the southern sector of the country will not help consolidated development.

This paper recommends one of two approaches that can save the situation described above. First, Ghana can follow the Japanese example where two tier banking systems run *pari passu*. They have the first-tier banks (financial conglomerates), are large and very service large firms in the country. Then they have the second-tier banks smaller than the first-tier banks that focus mainly on SMEs. The other

recommendation is that the stated capital be reduced to about GH¢ 40 Million which will represent 6-fold recapitalization of the present GH¢ 7 Million. At least that will ensure that stronger Ghanaian banks will survive. The Department of Banking Supervision of the Bank of Ghana must monitor any traces of conspiracy by foreign banks to hold the nation to ransom; in terms of increasing interest rates, shunning the SME segment of the economy, high banking charges etc.

IMPLICATION AND CONCLUSION

The paper theorizes that when banks grow bigger than the the rate of growth of the economy, credit available to SMEs decrease. After analyzing the effects of bank consolidation in several other countries, the possible trend is that any country where the capitalization was very ambitious, SMEs do not get the necessary attention. The paper concludes that the impending bank consolidation is likely to lead to credit crunch among SMEs because it is likely to reduce access to relatively cheap and stable funds that could provide a reliable source of credit to the productive SMEs at affordable rates of interest. The apathy of banks towards small savers, particularly at the grass root level outside the regional capitals, has not been addressed by the Bank of Ghana policy. Finally, the research fills the gap in the Ghanaian banking consolidation literature that points to only the positive aspects of the exercise.

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