Financial Market Regulators and the Costs Associated with Regulatory Forbearance in Ghana

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Abstract

Financial market regulation is key to maintaining market discipline and conduct. Regulations in Ghana has resulted in market clean up and sanity. The enforcement of regulations by Regulators has it associated costs and benefits to the actors in the financial space and the bigger economy as a whole. This paper will give background to financial regulation, the costs and benefits associated with regulatory forbearance. Finally, it discusses the recent impact of regulatory forbearance in the financial market of Ghana.

Keywords: *Regulations, Regulatory Forbearance, Financial Market*

Introduction

Regulations in the financial market are justified due to the market imperfections in the financial systems. Financial markets have inherent vulnerabilities to market failures, thus regulations are needed to mitigate against the impact of market failures (Mensah et al, 2018). The Financial Technology (FinTech) industry is the new financial wave in Ghana without a comprehensive regulatory framework.

In Ghana, the financial markets are regulated by separate regulatory agencies. The banking sector is regulated by Bank of Ghana (BoG), the capital market by the Securities & Exchange Commission (SEC), insurance industry by the National Insurance Commission (NIC) and the pension funds by the National Pensions Regulatory Authority (NPRA). The type of regulatory framework practiced in Ghana since independence is referred to as the 'silo' approach where a single regulator is responsible for prudential and market conduct for a specific industry within the financial market. The Bank of Ghana through the Specialized and Deposit-Taking Institutions Act2016 (Act 930) is responsible for both the prudential and market discipline in the banking system. The other regulatory frameworks include Securities Industry Act2016 (Act 929), Insurance Act 2006 (Act 724) National Pensions Amendment Act2014 (Act 883) used by the SEC, NIC and NPRA respectively.

Regulators of the financial system have the authority to revoke the license of financial institutions but occasionally recline to forbearance and allow distressed financial intermediaries to continue to operate. However, regulators resort to delays in shutting down financial institutions because of political pressure (Mishkin 2000; Dinç 2005) or the financial exposures in the financial system (Brown and Dinç 2011; Morrison and White 2013).

Background

It is not surprising that financial regulations and reforms has become the foremost element of discussion by most regulators after the 2008 financial crises. Regulation comes with benefits such as financial soundness and stability, but it also imposes costs.

The global financial crises of 2008 raised some fundamental questions about the conceptual foundations of financial regulations. Conservatively, capital requirements have been the bedrock of financial regulations (Morris & Shin, 2008). The Basel 3 introduced capital and liquidity standards to strengthen the regulation, supervision and risk management of the whole banking system. Jaques & Nigro (1997) suggested that risk based capital standards are effective in increasing capital ratios and reducing portfolio risks in banks.

Brinkmann & Horvitz (1995) states that regulators in the US faced serious criticisms when capital requirements were raised in the 1970s and 1980s, because it placed the US owned banks at a disadvantaged position compared to the foreign banks. The same criticisms were leveled against the BoG by the locally owned banks in 2018 when banks were to obtain a Minimum Capital Requirement (MCR)of GH¢400million (about 233% from the previous MCR of GH¢120million). However, the1988 Basel agreement on risk-based capital recommended new but not necessarily higher capital requirement on banks was able to resolve the situation in the US. This meant that banks with risky assets were required to have higher capital. The risk of off-balance sheet transactions such as Options, Futures and other financial derivatives, were taken into consideration, and banks were required to hold capitals against such contingent obligations.

Following the 1988 Capital Accord, the 1996 Market Risk Amendment and the 1999 Capital Adequacy Framework by the Basle Committee on Banking Supervision, banking regulation is taking shape around the world (Chorafas, 2000). This goes further to confirm that financial market regulation will always be needed as a check and balance on the financial system. The Government has a role in financial markets; however, the success of such interventions has had mixed results (Stiglitz, 1993).

A critical review of financial consolidation literature has four main thematic goals. Pellerin et al (2009) put them as (i) to take advantage of economies of scale made possible by the consolidation of regulatory agencies; (ii) to eliminate the overlaps and duplication that arises through the 'silo' approach of regulation; (iii) to improve accountability and transparency of financial regulation; and (iv) to adapt the regulatory structure to the increased prevalence of conglomerates in the financial industry.

Consolidation of financial market regulations in Ghana could overburden and put so much power over the financial system in the hands of a sole regulator. The silo approach of financial regulation practiced in Ghana is functioning well, although not perfectly due to lack of co-ordination and pro-activeness on the part of the regulators. However, it would be better to segregate the prudential regulation and market conduct of the regulators in Ghana. While prudential regulation looks at robustness and stability of financial intermediaries, market conduct deals with consumer protection in the financial space.

A critical review of the various financial market acts, namely Specialized and Deposit-Taking Institutions Act 2016 (Act 930); Securities Industry Act 2016 (Act 929); Insurance Act 2006 (Act 724); National Pensions Amendment Act 2014 (Act 883); reveals that the Act 930 and Act 724 largely deals with prudential regulation whiles Act 929 and Act 883 mostly deals with market conduct. A single financial market conduct regulator could be established to co-ordinate and oversee consumer protection function in the banking, securities, insurance and pensions industry in Ghana.

Literature on forbearance turns to focus on the cost of resolving banks (Benston & Carhill, 1992; Bartholomew, 1991) and whether forbearance restore financial intermediaries to viability (Legget, 1994). Regulatory forbearance is viewed by regulators as a way of managing distressed banks to return to efficiency and viability.

Proponents describe forbearance as an enlightened supervision, while its opponents view it as a costly foot-dragging exercise (Leggett, 1994). However, forbearance can be a prudent regulatory measure if the distressed banks return to viability without costly intervention (Santomero & Hoffman, 1998) or if revoking the license of the bank will undermine public confidence in the financial system (Allen & Gale, 2000; Morrison &White, 2013). Regulators can only described a financial intermediary as distressed after reviewing its financial information and operations. Therefore, opacity in accounting information enable regulatory forbearance as suggested by Gallemore (2013).

Discussion

Central banks around the world have pursued financial stability as the main objective throughout their existence and the interpretation of their role in doing so has varied in modern times (Goodhart, 2011). A robust and stable financial system is resistant to economic shocks and also serves the foundation for economic development. The Government of Ghana through an Executive Instrument has establish the Financial Stability Council, which is tasked with the sole responsibility of enhancing the stability and soundness of the financial system in Ghana.

Financial market regulators have the sole responsibility of maintaining public confidence in the financial ecosystem. This has become necessary because of the internationalization of financial markets and the rapid advancement of technology (Chorafas, 2000). Public confidence in the financial system enables economic growth.

Recent incidents in Ghana where regulators forbore in closing troubled financial intermediaries includes MenzGold, Royal Bank and UniBank. In the case of MenzGold, the SEC resorted to forbearance and issued out notices warning the public not to trade with MenzGold instead of implementing section 109 and 206of the Securities Industry Act (Act 929) which talks about licenses and penalties for operating without a license. MenzGold operated a gold collectibles scheme without a SEC license for over five years before its operation was suspended by SEC.In the case of the Royal Bank and UniBank, the BoG delayed in revoking their licenses in accordance with section 16 (1) – (8) of the Specialized and Deposit-Taking Institutions Act (Act 930) with the hope that these banks will return to viability. The Asset Quality Review undertaken by BoG in 2016 identified both Royal Bank and UniBank to be significantly undercapitalized; however the BoG revoked their license in August 2018. As discussed earlier, a regulator may forbear due to political reasons, to maintain the public confidence and health of the financial system.

Arguably, the main benefits of forbearance in the short run is that it could save jobs and future tax income the government could accrue if the troubled financial institution can overturn it difficulties around and become solvent. The effects of unemployment and loss of revenue to government through taxes can be avoided where regulators recline to close down troubled banks immediately. Thus, forbearance is a gamble that regulators sometimes have to play.

Furthermore, forbearance could limit costly litigation and provides an avenue for troubled financial intermediaries to revive their viability. Litigation costs are generally high, and thus regulators ability to recline for some time in order to gather sufficient appropriate information before revoking the license of a distressed bank could save the regulator from long and costly litigation.

Critics of regulatory forbearance argue that delayed action increases the tendencies of high cost of closures (Gissy, 2000). The ultimate burden of cost is the taxpayer. The 2017-2019 banking system clean up in Ghana cost the taxpayer over GH¢8 billion and an additional GH¢700 million as a result of the microfinance and savings & loans clean up.

Also, forbearance impedes the efficient allocation of resources within the banking sector. The central bank uses taxpayers' funds to provide liquidity support for distressed banks and thus putting sound banks at a disadvantage position. Short term liquidity support that would have otherwise be allocated to sound banks to channel it to productive ventures would be used to support distressed banks to meet depositor's withdrawals and other short term obligations.

Again, forbearance encourages risky behaviors in the financial systems. Thus, it encourages top bank executives to embark on very risky activities with the aim that should the bank become insolvent the regulator will provide liquidity support and drag its feet to shut it down until the bank return to solvency.

Conclusion

The growth of financial conglomerates around the world has led a number of countries to consolidate their financial regulatory agencies. However, Ghana needs to enhance it markets discipline standards before it later consider consolidating it financial regulations. It is not a simple task to close down financial institutions; regulatory forbearance has its own merits and demerits to be considered before a regulator revokes a license of a bank or any other financial intermediary.

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