# POLICY BRIEF

**Title**: *Agency Conflict and Bank Interest Spreads in Ghana*

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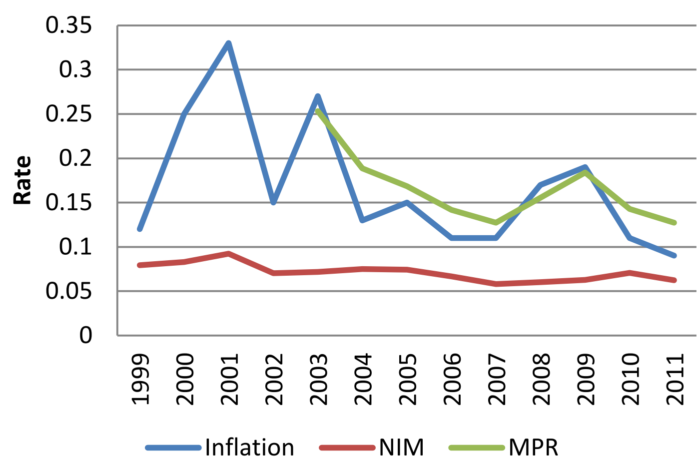
### *Policy Motivation for Research*

Since the 1980s, Ghana has been implementing a comprehensive financial sector reform programme aimed at making the financial sector more efficient in performing the key economic functions of mobilizing and allocating financial resources. Policy initiatives designed to improve the banking sector have included the privatization, removal of sectoral credit allocations, elimination of interest rate controls and liberalization of the foreign exchange market. Despite these wide ranging reforms, interest rate margins have been persistently high. Figure 1 shows that the net interest margin has not followed the trend in inflation and the monetary policy rate. Whereas, the inflation rate and the monetary policy rate have declined, the net interest margin has remained almost unchanged.

**Figure 1 Inflation, Monetary Policy Rate and Net Interest Margins**




The high and persistent interest rate margins suggest a high degree of bank inefficiency. Such high spreads are manifested in low deposit rates that discourage savings and high loan rates that discourage investment and ultimately economic growth. The policy debate in Ghana has been about what to do to reduce bank interest rate spreads without reintroducing interest rate controls. Previous empirical studies have tended to investigate the role of bank-specific financial factors such as collateral, capital, liquid assets, operating expenses and loan quality as determinants of the bank interest rate spreads. While most studies attributed the high interest rate margins to operating inefficiencies in the banking system, they did not offer useful policy direction for the government.

The purpose of this study is to contribute to the research in interest rate margins by considering the role of managerial incentives on the setting of interest rate spreads. Bank executives as agents of shareholders are mostly interested in managerial goals such as salary and perquisites to the detriment of shareholder value maximization. Also, banks' inefficiencies or underperformance is often reflected in high interest spread and executives tend to bear little or no cost because they are not the principals. Bank interest rate margins may therefore be a function of the extent of agency conflict in a bank. Departing from previous studies, this study examines the relationship between interest rate spreads in the Ghanaian banking industry and variables that reflect convergence/divergence between managerial self-interest and corporate goals of which the key variables are structure and size of executive compensation and bank ownership structure.

### *Findings*

The results thus show that non-alignment of goals between bank owners and management contributes significantly to explaining the high interest rate spreads in Ghana. The key results of this study are as follows:

- Emoluments of directors' and staff are positively related to the interest rate spread. In the absence of other strong corporate governance mechanisms, banks tend to be motivated to charge high interest margins since they can extract these from the firm by paying high salaries to their directors and staff.
- Among bank-specific factors employed, we found a statistically significant relationship between bank size and net interest margins. The results show that, larger banks tend to exhibit a larger spread compared to smaller banks. The evidence here suggests that larger banks are not benefiting from scale economies which should result in lower costs and a lower net interest margin. In fact, banks may be suffering from diseconomies of scale which have contributed to higher costs and margins. Indeed, larger banks charge higher margins to compensate for their investments in technology and branch networks. In Ghana, the largest banks have the largest branch networks and have made significant investments in technology.
- In terms of the industry level effect, the results of the study show that the level of concentration within the banking industry, affects interest rate spreads in Ghana. The Herfindahl Index, which proxies for concentration, suggests a significantly positive relation with the net interest spread. This suggests that as the banking industry becomes more concentrated, the tendency is for banks to charge monopolistic rents and thus exhibit higher margins.
- We find evidence suggesting that to a certain extent, the Central Bank has some influence on bank net interest margins. Similar to the findings of previous studies there is we find a positive relation between the level of bank risk aversion (proxied by the capital adequacy ratio) and bank net interest spreads.
- Reserve requirements implemented by the monetary authority to promote financial stability contribute to the high spreads of banks. To the extent that such reserves are unremunerated and as such represent a cost, banks tend to charge a higher margin to compensate for the opportunity cost of not having access to these funds.
- Macroeconomic factors influence the level of bank interest spreads. Specifically, we find a positive relation between the level of inflation and bank interest spreads. The findings here indicate that, the level of inflation feeds into the net interest margin of banks in Ghana. If bank lending and deposit rates are equally affected by changes in inflation, then there should be no net effect on the net interest spread of banks. However, the results suggest that the lending rates of banks are more sensitive to inflationary pressures compared to their deposit rates.

### *Audience*

This brief is intended to support the policy role of the Ministry of Finance and Economic Planning and the Bank of Ghana. Other stakeholders include the Ghana Association of Bankers and representatives of the private sector such as the Private Enterprise Foundation and the Ghana National Chamber of Commerce and industry. Industry representatives have been very vocal about the banking sector and have consistently demanded policy actions from the government to bring down interest rates. Bank boards and senior management will also benefit from the findings of this study.

## *Policy Implications*

The key policy implication is that improved corporate governance of banks will have favourable effects on the interest rate spreads by reducing the conflict between managerial self-interest and corporate goals. Incentive compatible compensation arrangements that align the interest of bank managements with shareholders will improve the efficiency of the banking sector by reducing intermediation costs.

In addition to corporate governance, regulators should ensure that the banking sector remains competitive so as to curtail high interest spread. Further, regulators should balance the requirements to maintain certain levels of capital adequacy and reserves to promote financial safety against the need to reduce the social cost of financial intermediation (bank net interest margins). The need to keep inflation within reasonable levels is paramount since the level of inflation tends to feed into bank interest spreads. In this regard, a persistent effort to reduce the current high levels of government budget financing will go a long way to reduce inflation and ultimately bank interest spreads.

## *Further Readings*

There is a rich literature on bank interest rate spreads as well as corporate governance in Ghana. The seminal work on agency cost is attributed to Berle, A. A., Jr. and Means, G. C. (1932), The Modern Corporation and Private Property, (Macmillan, New York, NY) and Jensen, M. C. and Meckling, W. H. (1976), Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure, *Journal of Financial Economics,* 3, pp. 305-360. A comprehensive analysis of interest rate spreads in Ghana may be found in Aboagye, AQQ, Akoena, S. K., Antwi-Asare, T. O. and Gockel, F. A. (2008), Explaining Interest Rate Spreads in Ghana, *African Development Review*, 20(3), 378 – 399. An analysis of the state of corporate governance in Ghana is provided in The World Bank, *Report on the Observance of Standards and Codes: Corporate Governance Country Assessment*, Ghana, May 2005