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## Is Traditional Banking Declining? An Empirical Analysis of Banks in Ghana

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### Abstract

Banks are traditionally into the business of mobilizing deposits and making loans. This generates interest income and has been a substantial proportion of bank's total earnings. Studies have shown that income from the traditional banking business has declined substantially in recent times. This paper examines the state of traditional banking in Ghana by relating interest and noninterest income from the year 2003 - 2012. We found that traditional banking remains strong in Ghana and interest income constitutes a higher proportion of total bank earnings. In recent times however, noninterest income has gained prominence as margin income deposits continue to squeeze.

**Keywords:** Traditional Banking, Interest Income, Noninterest income, Banks, Ghana

### Introduction

Commercial banking has become a very important business activity which has contributed to the advancement of economic activities around the world. The world economy revolves around finance and financial activities which are predominantly undertaken by the banking sector. In the words of Huang and Chen (2006), "Banks are the financial intermediaries providing the platform to connect the capital demanders and suppliers". For many centuries, banks were way out in front of other financial services institutions in supplying savings and investment services, payment and risk protection services, liquidity and loans. They dominated the financial system for decades but this is no longer as true today as the financial market share of banks has generally fallen due to the scuffle by other financial institutions for the same turf (Rose and Hudgins, 2008). This they posit is viewed by some as an indication of a dying traditional banking system. Other experts counter that banking is not dying, but only changing – offering new services and changing its form to reflect what today's market demands.

In an emerging economy like Ghana, the banking sector has seen tremendous growth in size and competition. Having evolved since its liberalization in the 1980s, Ghana's financial

industry and banking sector have seen many changes not only in the number of banks<sup>1</sup> and financial institutions but also in the diversity of products and services they render. The number of banks in Ghana stood at 26 as at December, 2012 and the value of the industry's total assets stood at GH 27.1b according to the (Ghana Banking Survey, 2013). Even though traditional banking and interest income constitute a major aspect of the banking business and source of bank revenue in Ghana, there are concerns about bank's ability to mobilize adequate deposits to promote their traditional loan making business. The National Stability Report (2013) indicates that; "the reserves of commercial banks in the country have been on consistent decline since the first quarter of 2013 following a sharp increase in the withdrawal of deposits and saving by their customers. The development which was first noticed by the Bank of Ghana (BoG) in March, 2013, has affected the deposit portfolios and loan books of various banks, partly resulting in the general squeeze in credit supply to the private sector in recent times". This could be an indication that the declining state of traditional banking in the developed world (US and EU) as established in literature has begun to occur in developing countries and Ghana for that matter. This may limit the deposits needed by commercial banks to finance their traditional lending business, forcing them to refocus their strategies towards exploiting noninterest income generating avenues. According to Demirguc-Kunt and Huizinga (2010) expansion into noninterest income-generating activities increases the rate of return on assets, and it could offer some risk diversification benefits at very low levels. This paper attempts to analyze the revenue streams of banks in Ghana to establish whether the decline in traditional banking as reported in the developed world is being replicated in Ghana and discusses the extent to which the outcome could affect banking and the financial sector as a whole.

### Literature Review

Financial deregulation around the world has resulted in many changes ranging from increased competition and concentration to restructuring. Banks have reacted to the new environment by adopting a proactive strategy widening the range of products they offer to their clients. These changes mainly implied an increasing share of noninterest income in profits (Lepetit *et al.*, 2007). Financial stabilization and deregulation have had important implications on the income statements of banks: there has been a shift from net interest income to noninterest income not dependent on traditional financial intermediation. The decline in interest margins has changed the traditional role of banks and has forced them to search for new sources of revenue such as trading, services and other financial operations (Albertazzi and Gambacorta, 2009). According to Rose and Hudgins (2008), some of the revenue comes from the sale of traditional services, such as charges associated with the use of checking and saving accounts, fees for the use of ATMs and commitment fees to extend a loan in the future when a customer needs it. Literature has established to a large extent that the traditional banking business which mainly generates interest income is declining in recent times. Since the mid-1980s, dramatic changes in regulation demand composition and technology have modified the structure and the boundaries of credit markets (Bhattacharya *et al.*, 1998). Huang and Chen (2006) for instance provided that income from traditional activities which are mainly interest income, have squeezed in recent times due to declining interest rates. According to Aggeler and Feldman (1998) in the US, while net interest income

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<sup>1</sup> The banking sector has recorded a number of mergers and acquisitions such as those between; UT Financial Services and BPI Bank, Ecobank and The Trust Bank, Access Bank and Intercontinental Bank as well as Bank of Africa and Amalgamated Bank.

of banks (Ninth District United States banks) rose by 12% over the period 1992–1997, the biggest gain in bank earnings came from noninterest income which grew by 34% in that period – nearly three times as fast as interest income. Clark and Siems (2002) also provided that commercial banks' share of total US financial intermediation assets (interest income) has fallen from 35% to 20%. Stiroh (2004) also found that noninterest income which represented 19% of US commercial banks' total income in the 1980s grew to 43% of total income in 2001. With the decline in interest margins induced by higher competition, banks were incited to charge higher fees on existing or new services such as cash withdrawal, bank account management and data processing. As a result, the structure of bank income experienced a dramatic change in both the US and Europe (Lepetit *et al.*, 2007).

Greater competition has diminished the cost advantage banks had in acquiring funds and has undercut their position in loan markets. As a result, traditional banking has lost profitability, and banks have begun to diversify into new activities that may bring higher returns (Smith *et al.*, 2003). Erji *et al.* (2012) however posit that the continued expansion in the component of noninterest income lowers risk-adjusted returns. Although noninterest income plays an increasingly important role in operating incomes of banks, interest income remain a major source of their operating income (Huang and Chen, 2006). Bawumia *et al.* (2005) affirmed that interest income constitutes the largest proportion of income for banks in Ghana and a major component of this interest income is loan interest. According to the Ghana Banking Survey (2011), the Ghanaian banking industry depends heavily on interest income as banks continue to focus on their core activities rather than their non-fund based activities like cash management services and financial commitments. According to Gup and Kolari (2005), most of the functions performed by banks for their customers can be divided into the three broad areas *via* Payments, Intermediation and Other financial services. Most of these services in recent times have been taken over by non-bank financial institutions thus limiting the market share of banks in these traditional areas of operation. Rogers and Sinkey (1999) posit that reduction in bank market share suggests that growth in non-bank intermediaries, such as pension funds and mutual funds, and growth in the instruments of direct finance, such as commercial paper and corporate bonds, have occurred at the expense of commercial banks and raises questions about the long-run viability of traditional banking, defined as the business of financing loans with deposits. The situation in Ghana can be attributed to the upsurge of microfinance, savings and loans and other financial services firms, favorable Treasury bill rates as well as recent sovereign bond issues by the Bank of Ghana. Fee income has become an increasingly relevant aspect of banks' income composition in recent times as various studies in recent times consider the nontraditional banking components of bank's financial statements in estimating their performances (see Lozano-Vivas and Pasiouras, 2010; Altunbas *et al.*, 2000; Jagtiani *et al.*, 1995; Pasiouras, 2008). DeYoung and Rice (2004) attributed the increased importance of fee income at commercial banking companies to structural changes like industry deregulation, new information technologies, and financial innovation. These are evident in the Ghanaian banking industry as revenue from fees and commission keep increasing on a yearly basis<sup>2</sup>.

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<sup>2</sup> On the average, fees and commission has more doubled annually over the last decade.

### Methodology of Research

In finding the state of traditional banking in Ghana, we calculate the total bank revenue from both traditional (interest income) and nontraditional (noninterest income)<sup>3</sup> activities for the entire industry and relate them to annual earnings (profit before tax) to provide a general picture of the relative trends over the period under consideration. We also examine the annual and cumulative changes in the two income components (interest and noninterest income) to ascertain the true state of interest income over the period, relative to income from other sources. Since traditional banking depends primarily on core deposits from bank customers, we also examined the customer deposits mobilized by banks over the period.

### Discussion of Findings

Considering the absolute values of revenue from traditional and nontraditional banking, as well as overall bank earnings (PBT), from the year 2003–2012, it can be seen from the figure 1 that all the variables have been on the ascendancy over the period. However, bank lending slowed and interest rates fell in 2010 while noninterest income and profit before tax maintained upward trends. The inflection of the interest income curve could be a signal that banks in Ghana are beginning to struggle in the traditional deposit mobilization and loan making business. The trend however confirms the position of DeYoung and Rice (2004), that revenue from nontraditional activities is coexisting with, rather than replacing margin income. The overall trend however affirms the assertion of Bawumia *et al* (2005) that interest income constitutes the largest proportion of income for banks in Ghana.

Table 1 shows the absolute values and changes in net interest income, noninterest income and profit before tax. They all experienced substantial increases over the period. However, the cumulative increase in noninterest income (270.29%) exceeded that of net interest income (256.83%), an indication of the increasing relevance of noninterest income in the banking sector. An examination of the data showed a general rise in bank deposits and current accounts over the period. These increases have however slowed 2006 as shown in figure 1. The year-on-year changes over the period indicate that deposits and current accounts are rather increasing at a decreasing rate.

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<sup>3</sup> Interest income is the difference between interest revenue and interest expenses whereas noninterest income consists of the sum of fees, commission and other income as captures in the bank income statements. The data used for the analysis was obtained from the Ghana Association of Bankers (GAB).

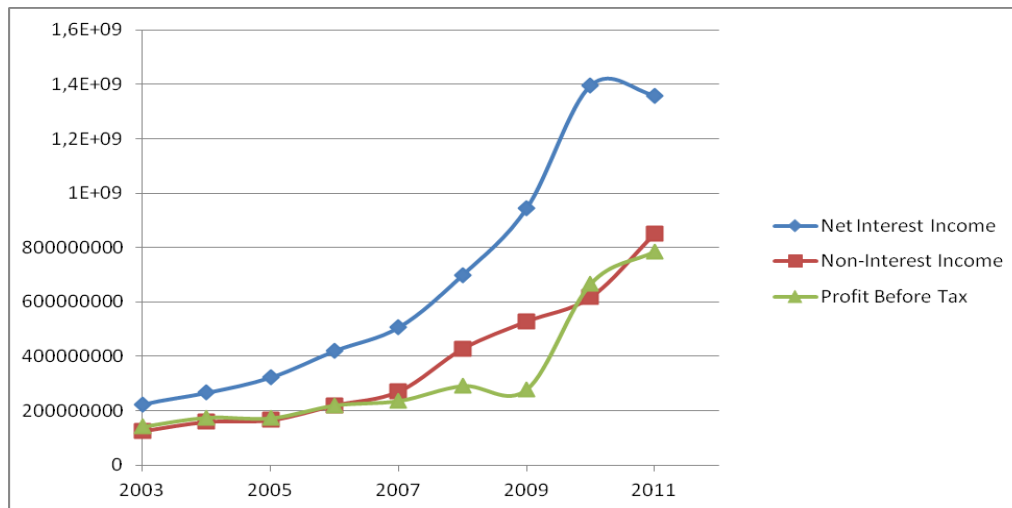


Figure 1. Trend of interest income, noninterest income and profit before tax (2003-2012)

Table 1

Net interest income, noninterest income, profit before tax and their relative changes

Years	Net Interest Income	NII(%Δ)	Non-interest income	NII*(%Δ)	Profit before tax	PBT(%Δ)
2003	223,645,050	47.58	126,370,803	48.18	142,660,053	40.30
2004	266,430,457	19.13	160,044,856	26.65	175,590,125	23.08
2005	322,872,251	21.18	166,820,242	4.23	173,558,607	-1.16
2006	420,502,169	30.24	221,104,911	32.54	220,596,389	27.10
2007	506,911,339	20.55	272,275,070	23.14	236,903,910	7.39
2008	699,704,613	38.03	429,264,639	57.66	291,933,645	23.23
2009	944,868,255	35.04	529,639,464	23.38	279,192,488	-4.36
2010	1,395,126,470	47.65	618,480,162	16.77	666,689,306	138.79
2011	1,359,248,831	-2.57	851,867,404	37.74	784,690,963	17.70
	<b>Cumm.(%Δ)</b>	<b>256.83</b>		<b>270.29</b>		<b>272.08</b>

Where: NII – Net interest income; NII\* - Noninterest income.

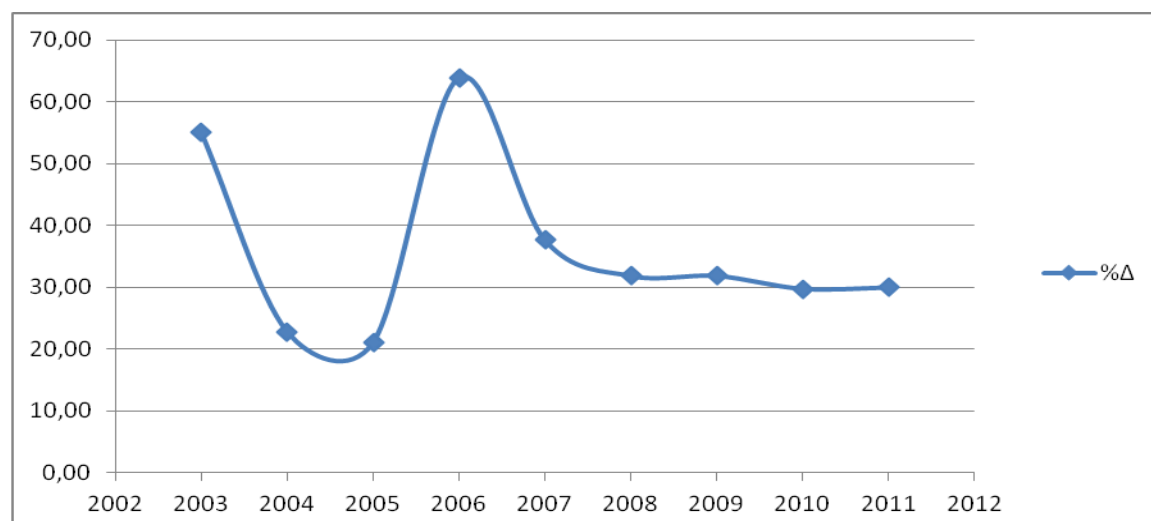


Figure 2. Changes in bank deposits and current accounts from 2003 – 2011

### Conclusions

The banking business around the world plays a major role in the business of financial intermediation and has grown over the years, resulting in the diversity and complexity of its



operations. Based on this development, banks have evolved from what used to be their normal line of business – mobilizing deposits and making loans, to other financial intermediation services. It has been established in literature that the traditional banking business of deposit taking and loan making has been declining in recent times due mainly to financial sector liberalization, competition and advancements in information and communication technology. The Bank of Ghana has expressed worries about dwindling banks deposits in recent times. The monthly Financial Stability Report of June 2013, for instance, showed that total deposits of the industry grew by 13.3% to GH 18.03 million in that month compared to a 33.2% year-on-year growth rate recorded in June 2012. The trend continued into September where the report indicated that deposits of the banking industry grew by 15.7% Gh¢17.6 million as against a 27.2% year-on-year growth rate posted within the same period in 2012. The objective of this study was to provide evidence as to whether traditional banking is declining in the Ghanaian banking sector or otherwise. We examined the trend of the various revenue sources and for customer deposits which constitute a major source funds for bank's traditional operations. We found that traditional banking and interest income remain a major source of revenue for commercial banks in Ghana. Over the study period however, it was found that on a cumulative year on year basis, non-interest income has earned banks more revenue than interest revenue. Customer deposits and current accounts have also slowed over the last few years. These findings show that traditional banking in Ghana is not as vibrant as it used to be as banks are increasingly relying on non-interest activities to defend their profits. It has implications for banking companies and the Central Bank who ought to formulate appropriate strategies aimed at enhancing domestic savings (deposits) with commercial banks towards the furtherance of traditional banking activities which provide the needed funds for deficit units for economic expansion.

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