MODULE - 3

CORPORATE GOVERNANCE AND EMERGING REGULATORY REQUIREMENTs

LEARNING OBJECTIVES

- Discuss the impact of the Pillar II of the Basel II/III-IV on the primary prudential requirements for Development Financing Institutions.
- Analyze the effect of these requirements on Board Accountabilities and Code of Responsibilities.
- Discuss how the new Business Model Analysis (BMA) Exposure Draft would support the operations of DBG to assess the viability and sustainability of PFIs.
- Discuss the risk management challenges and implications of these prudential requirements.

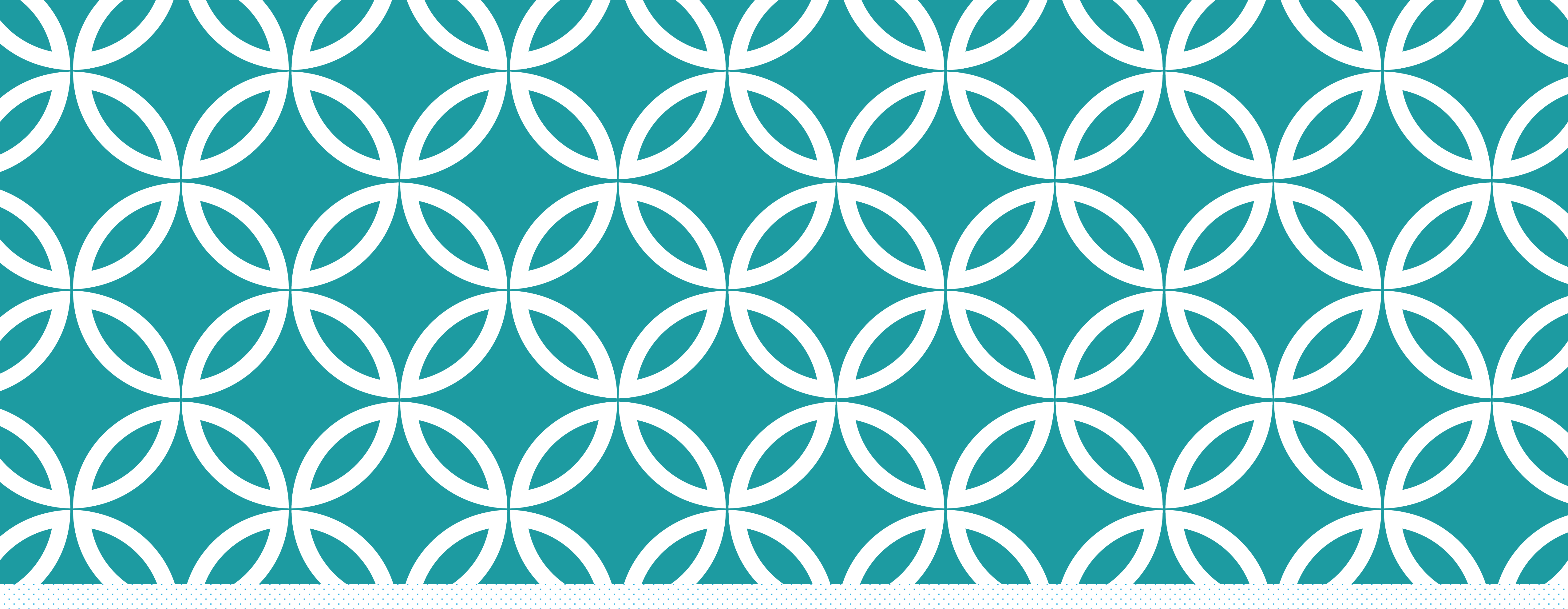
LEARNING OUTCOMES

TECHNICAL

- Employ the new BMA framework to improve the Corporate Governance of DBG.
- Promote viability and sustainability of the Bank through value-based management tools.
- Sustain the Corporate Governance Disclosure Requirements to provide market assurance.

BEHAVIOURAL

- Zero tolerance for non-compliance with laws and regulations that have associated administrative penalties.
- Actively monitor capital, liquidity and social investment positions of the Bank's resource allocation.



EMERGING CORPORATE GOVERNANCE ISSUES

GOVERNANCE IN BANKS

INTRODUCTION

The current regulatory expectations in relation to the governance of banks are centred not only on regulatory conformance but also regulatory performance that requires the balancing of laws and regulations and the ability of Directors to assure and ensure the viability and sustainability of banks.

The traditional or soft side of regulatory conformance relates to issues of fit and proper, board size, tenure, meetings, effective board psychology, board evaluations and succession planning.

INTRODUCTION- REGULATORY PERFORMANCE

Regulatory performance is of great concern to regulators because of the seeming gap between governance expectations (by satisfying the soft governance criteria), and the nature of what is reported within the banks from Management to the Board and to the Regulators and the adequacy of institutional preparedness towards emerging and potential risks including the transient effect of shocks that tend to overwhelm the Board and or tend to collapse the banks.

INTRODUCTION- REGULATORY PERFORMANCE

Regulatory performance is an enhanced mechanism on the part of Regulators that tend to drum home the need for the Board of Directors of Banks to practically understand the deep-dive into the risks identified, analysed, measured and their monitoring and controlling approved and manifested through the banks operating business model.

INTRODUCTION-REGULATORY POSTURE

The Regulatory Posture has been the desire that Board of Directors of Banks are grounded in both the theory and practice of the real business encounters that they superintend over.

In other words, the force of governance lenses defined to include Directors' accountabilities is quantified by the extent to which the viability and sustainability of the bank is guaranteed or assured. This position is supported by the recent Exposure Draft on Business Model Analysis (2023/2024) by the Bank of Ghana.

INTRODUCTION- THE GOLD STANDARD

This Gold Standard in Corporate Governance is backed by law in the Companies Act, 2019, Section 131 and in many jurisdictions including the UK (Provision 31 of the 2018 UK Corporate Governance Code) and follows the intention behind the Pillar II, Supervisory Risk-Based Approach by the Bank of Ghana to supervise the banking sector.

Again, it is also enshrined in Section 71 (1) (a) and (b) of the Development Finance Institutions Act, 2020 Act 1032.

INTRODUCTION- IIRF

The International Integrated Reporting Framework (IIRF) is the current corporate reporting norm and has the following outline:

- Organisational overview and external environment
- Governance
- Business Model
- Risks and Opportunities
- Strategy and Business Resources
- Performance outlook
- Basis of Preparation and Presentation.

IR-GOVERNANCE AND BUSINESS MODEL

The ‘Governance’ part seeks to question how the Board of DBG and its related governance structures support DBG’s ability to create value in the Short, medium and long term.

While the Audit Committee of DBG may seek align the IR (2022) and the existing Financial Reporting Guideline (2017) issued by the Bank of Ghana, the ‘Business Model’ part requires the Board to explain DBG’s system of transforming inputs, through its business activities, into outputs and outcomes that aim to fulfil the Bank’s strategic purposes and create value over the short, medium and long term.

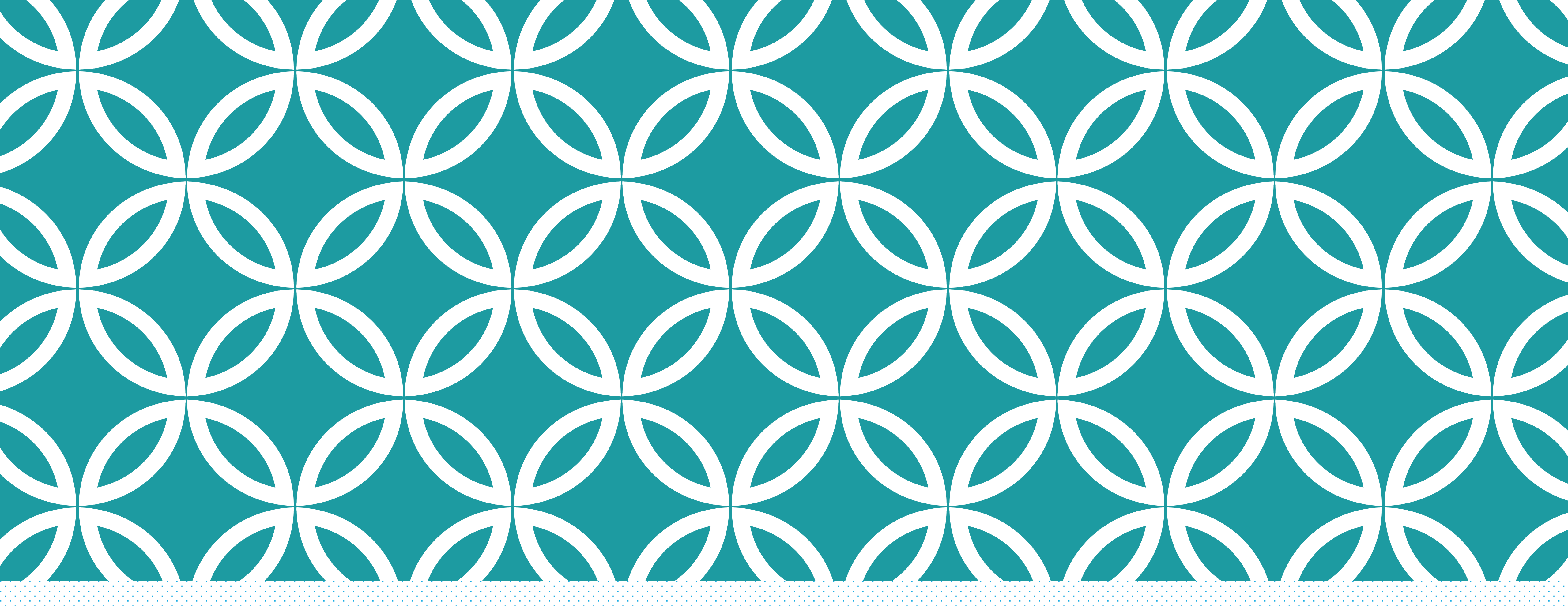
SUMMARY FACTORS DRIVING REGULATORY GOVERNANCE

Basel II/III-IV Regime

Recent Bank Failures and the effects of the DDEP

The Rise of the Accountability Regime in Bank Corporate Governance space

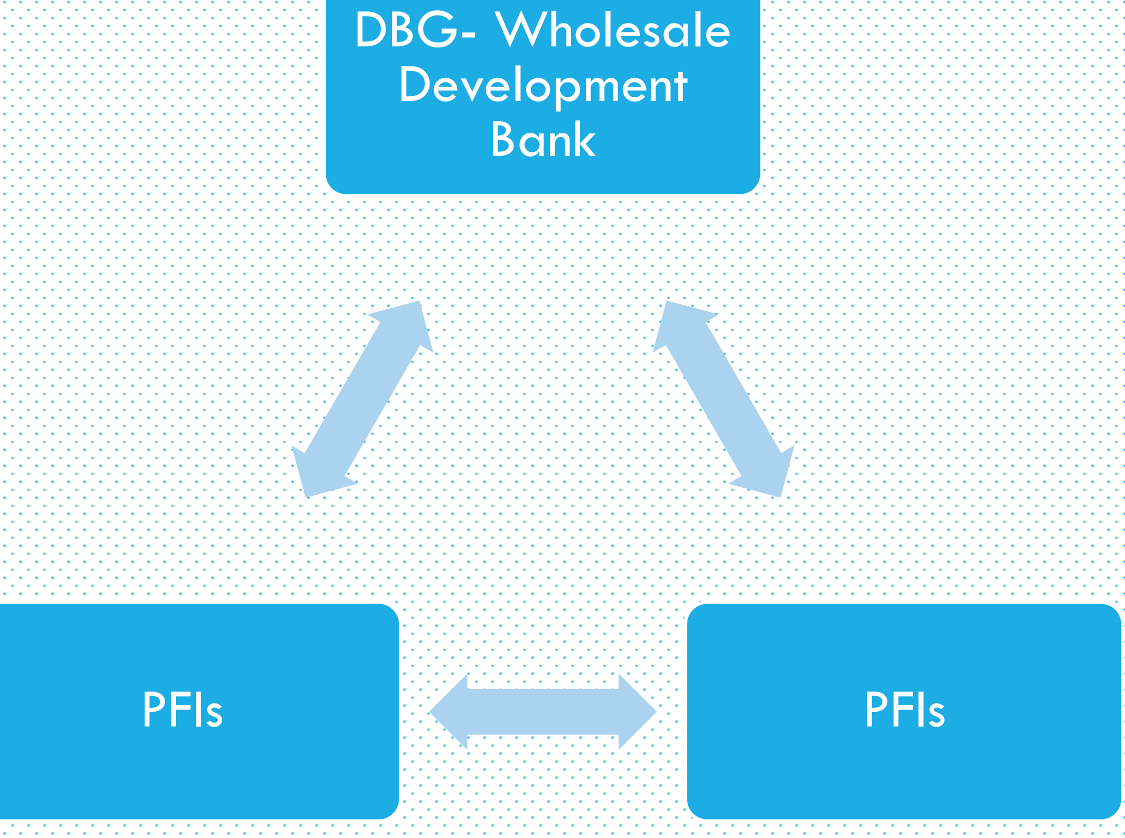
Satisfy International Integrated Reporting Framework Regime



VIABILITY AND SUSTAINABILITY-THE GOLD STANDARD

AN EMERGING REGULATORY ISSUE

DBG'S BUSINESS MODEL



DBG'S BUSINESS MODEL

The Development Bank of Ghana(DBG) is a wholesale development bank wholly owned by the Government of Ghana.

- The focus currently through the PFIs relate to the following sectors:
  - Small and Medium-sized Enterprises operating in Agri-business
  - ICT
  - High Value Services
  - Manufacturing

- (Source: DBG Disclosure of DBG Environmental and Social Management System, 2022)

EMERGING REGULATORY ISSUES

The Bank of Ghana intends to implement the Pillar II of the Basel Regime in Ghana. Directors are therefore expected to understand its implications of the risk governance of their institutions.

Central to this regulatory direction is the reinforcement of the Risk-based Supervisory approach to regulated firms.

Apart from the laws governing the set-up of DBG, there has been a raft of directives which directly or indirectly support the corporate governance of regulated firms.

EMERGING REGULATORY ISSUES

Directors are generally aware of the existence of the following:

- Development Finance Institutions Act, 2020 (Act 1032).
- The Anti-money laundering Act 2020, Act 1044
- The Land Act, 2020, Act 1052
- The Borrowers and Lenders Act, 2020, Act 1036.
- These laws are central to the strategic operations of the Development Bank of Ghana.

EMERGING REGULATORY ISSUES

In addition, there are specific regulatory guidelines that support the Corporate Governance of DBG. They include:

- The Corporate Governance Directive 2018
- The Corporate Governance Disclosure Directive 2022
- The Risk Management Directive 2021

DBG'S BUSINESS MODEL

Funding PFIs to on-lend to the Private Sector: DBG provides long-term, local and foreign currency financing through PFIs to MSMEs and small corporates operating in agribusiness. Manufacturing, ICT and high-value services.

PFIs (for example, banks, specialised Deposit-taking Institutions (SDIs) , Non-deposit-taking institutions(NDIs) and other credit providers will be qualified based on clear eligibility criteria encompassing regulatory compliance, corporate governance, financial soundness, operational capacity and outreach.

DBG'S BUSINESS MODEL

All types of licensed financial intermediaries that express interest, meet the eligibility criteria commit to using the DBG's funds according to agreed terms will be eligible to qualify as PFIs.

DBG is solely responsible for selecting PFIs based on a set of eligibility criteria and monitoring their compliance with DBG's financing agreement.

Source: Disclosure of Development Bank Ghana Environmental and Social Management System 2022.

DBG'S BUSINESS MODEL

To achieve the above, DBG provides technical assistance to PFIs that are customised to accelerate the utilization of the borrowed funds and develop sustainable lending approaches for the target segments.

It would include the development of Monitoring and Evaluation (M&E) systems, the upgrade of risk management systems, the establishment of MSME lending units/strategies, the development of sustainable lending approaches for target groups(for example, cash-based lending, gender –inclusive credit products and climate finance and training of staff. Reputable advisory firms support DBG in delivering the technical assistance.

DBG'S BUSINESS MODEL

Partial Credit Guarantee: DBG supports the establishment of a Partial Credit Guarantee product to derisk-a portion of the PFIs exposure on their MSME loans and increase their appetite to lend to MSMEs.

The argument support DBG's position is that currently, Ghana's financial institutions refrain from lending to creditworthy MSMEs that lack credit histories and sufficient collateral (mainly real estate) to satisfy lenders' minimum requirements.

Source: DBG (2022).

EMERGING ISSUES

DBG has successfully partnered with 6 universal banks to lend to MSMEs and small corporates. The banks include:

- CBG
- CAL Bank
- Fidelity Bank
- Access Bank
- Ecobank
- Zenith Bank

DBG has also partnered with Sinapi-Aba.

ON-BOARDING OF PARTICIPATING FINANCIAL INSTITUTIONS(PFIs)

MINIMUM QUALIFYING CRITERIA FOR ON-BOARDING PARTICIPATING FINANCIAL INSTITUTIONS (PFI)

1. Hold a valid license issued by the Bank of Ghana;

2. Be compliant with all applicable laws, directives and notices of the Bank of Ghana;

3. Demonstrate, within the three most recent financial years, two years of profitable lending operations, with effective risk management procedures, controls and acceptable levels of loan portfolio quality and performance, as prescribed in DFI's Credit Policy;

ON-BOARDING OF PARTICIPATING FINANCIAL INSTITUTIONS(PFIS)

4. Be compliant with the minimum standards of financial consumer protection and sustainable banking principles;

5. Be compliant with all other eligibility standards as prescribed in DFI's Credit Policy;

6. Fit and proper Board and Key Management Personnel;

7. Reliable management information systems; and

8. No objection from the Bank of Ghana.

DISQUALIFIED PFIs

A PFI shall be deemed not to be in good standing if that PFI:

1. is under a prompt corrective action from the Bank of Ghana;

2. receives a qualified audit opinion on its most recent audited financial statements;

3. is unprofitable for four (4) consecutive quarters at any time following the start-up period which shall be three (3) years from the date of commencement of business;

4. fails to meet its capital adequacy requirements as at the most recent examination and the PFI fails to inject additional capital to meet the regulatory threshold; or

5. is a borrower for which a DFI has received a written notice from the Bank of Ghana expressing material concerns about the PFI's financial condition or business operations resulting from its most recent supervisory inspection.

CORPORATE GOVERNANCE OUTCOMES

	INDICATORS	DBG's PERFORMANCE	BOG REQUIREMENTS	BASEL III-IV REQUIREMENTS
1	Capital Adequacy Ratio (%)	151%	10%	14%
2	CET 1	151%	6.5%	
3	Leverage Ratio (%)	56%	4.5%	5%+
4	Liquidity Ratio(%)	1582	10%+	100%+
5	NPL Ratio (%)	-	1%	-
6	Climate –rating Status	5-star Green rating	Nil	CVaR Required
The Basel III-IV measures liquidity ratios based on Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratios (NSFR). Both are set above 100+%. The LCR is set for 30 days under stressed conditions.				
	The above indicators show that the Board of DBG has governed the Development Bank as a CLASS A Bank.			

RISK GOVERNANCE CHALLENGE

Evidence based on recent 2022 Annual Report of DBG indicates that DBG, satisfies Basel III/IV governance standards, and qualify as a CLASS A bank.

The Basel Classification posses an operational risk challenge for DBG as many of the PFIs fall into CLASS B and C categories.

This situation justifies the recent development of an Exposure Draft (ED) on Bank Business Model Analysis in 2023/ 2024 on the need for the Board of DBG to review its own business model and the criteria set for selection of PFIs.

THE BUSINESS MODEL ANALYSIS -EXPOSURE DRAFT (2023/2024)

This Exposure Draft is based on the recent failures in the USA and other financial institutions. The Exposure Draft cites the cases of Northern Rock in the UK in 2008, Silicon Valley Bank(SVB) in 2023, Banks and other Specialised Deposit- taking Institutions(SDIs) in Ghana which had heavily invested in longer term Government of Ghana (GoG) securities were highly impacted by the Domestic Debt Exchange Programme (DDEP) with some of the PFIs required to recapitalize due to their solvency ratio falling below the minimum regulatory requirement.

VIABILITY AND SUSTAINABILITY

The Exposure Draft (2023) defines the viability of any Regulated Financial Institution's(RFIs) current business model on the basis of its ability to generate acceptable returns over the following twelve (12) months; and

The sustainability of the RFIs strategy on the basis of its ability to generate acceptable returns over a forward-looking period of at least three(3) years, based on its strategic plans and financial forecasts.

ACCEPTABLE RETURNS

The Exposure Draft draws the attention of Directors to infuse the principles of Value-Based Management as part of their assessment of their business models.

The first that returns should exceed the Cost of Equity (COE). This is the return that a firm theoretically pays its shareholders to compensate for the risk they are exposed to as a result of investment in their capital.

In the case of a Development Bank, the COE should be adjusted for shadow price effect due to the socio-political and economic dimensions of its objectives.

ACCEPTABLE RETURNS

- The second is the measurement of the Bank's Risk Adjusted Return on Capital (RAROC)

- The RAROC=

- $$\frac{\textit{Net Interest income} + \textit{other income} - \textit{Operating costs} - \textit{Liquidity Costs} - \textit{Expected Credit Loss}}{\textit{Economic Capital}\ (\textit{Total Regulatory Capital Requirement} - \textit{Basel Driven})}$$

ACCEPTABLE RETURN

Where:

Expected Credit Loss = Exposure at Default (EAD) x Loss Given Default x Probability of Default (PD)

Liquidity Cost = Refinancing cost for the bank which should take into account the refinancing maturity and currency and where applicable, Fund Transfer Pricing (FTP)

Economic Capital= Minimum regulatory capital requirement as per the Capital Requirement Directive (CRD) including where applicable any regulatory Pillar 2 capital requirements.

ACCEPTABLE RETURN

The RAROC at the enterprise and business lines (mapped to the Basel eight business lines for operational risk under standardized approach) should be compared with the hurdle rate and where RAROC is less than the hurdle rate then consideration should be given to requiring the bank to take the appropriate remedial action so as to preserve capital.

COMPLIANCE

The Board is expected that assurances by management indicate the following:

- Return on Equity does not fall below the cost of equity
- The Bank constantly maintain solvency status
- Cost to income ratio is always below acceptable regulatory level e.g. 70% and never above 100%.
- Interest expense should not exceed interest income.
- Minimize volatility, concentration or mismatch (maturity and currency) in funding mix. Develop or establish high-quality liquidity pool as required under Pillar 2 in Basel III and IV.

CASE STUDY

DBG is exposed to GHS1 billion MSME loan portfolio that offers a headline return of 9%. DBG has an operating direct cost of GHS 9 million per annum and an effective tax rate of 30%.

The portfolio is funded by GHS 1billion borrowed funds with a transfer priced interest charge of 6%.

Risk analysis of unexpected losses associated with the portfolio shows that the Bank need to set a economic capital of GHS 75 million (7.5% of the loan amount) against the portfolio.

DBG's Capital Policy requires that capital should be invested in risk-free securities and return tradable government instrument is 5%.

CASE STUDY –AN ANALYSIS OF RAROC

The Expected Loss on this portfolio is assumed to be 1% per annum (1% x GHS 1billion = GHS 10 million).

From the Case Study, the following information can be established:

- Expected Revenue = GHS 90 million
- Operating cost –direct=GHS 9 million
- Interest Expense (6% of the GHS 1billion) = GHS 60 million
- Expected Loss = GHS 10 million
- Return on Economic Capital (0.05 x GHS 75m) = GHS3.75

CASE STUDY- CALCULATION OF RAROC

If we ignore transfer price considerations, then :

$$\text{RAROC} = \frac{(90 - 9 - 60 - 10 + 3.75)(1 - 0.3)}{75} = 0.14 = 14\%$$

The RAROC for this loan portfolio is 14%. This can be interpreted as the Annual After –tax expected rate of return on Equity needed to support the loan portfolio.

IMPLICATIONS FOR CORPORATE GOVERNANCE

Where RAROC is used as ex-post and not ex-ante basis, realized revenue and realized losses are used to replace expected revenues and losses.

Where the weighted cost of equity capital is used as the hurdle rate, a simple decision rule for governance can be inferred :

If the RAROC ratio is greater than the hurdle rate, the activity is deemed to add value in the Bank.

In the opposite case, the activity is deemed to destroy value for the Bank and the activity should be closed down, project rejected or re-engineered.

THE BUSINESS MODEL EXPOSURE DRAFT (2023/2024)

- Most frequent cause of bank failure include:
  - Switching from a low-risk business model to a high-risk one
  - Pursuing rapid growth without having appropriate risk culture and risk management capacity
  - Poorly conceived and unrealistic business plans and / or inadequate execution of such plans.

Source: Adapted from Methodology for Assessing the Viability and Sustainability of RFIs' Business Model (2023/ 2024)

GOVERNANCE COMPLIANCE

VIABILITY STATEMENT & GOING CONCERN STATEMENTS		
Justification	Composition	Construction

GOVERNANCE COMPLIANCE-AWARENESS

Directors should justify the signing annual reports

This will reduce Market indiscipline challenges

Directors' duties and responsibilities are in action now

Directors must understand the future with rigour

No more speculative approach to governance

GOVERNANCE COMPLIANCE

OPERATIONAL RESILIENCE	Discuss operational resilience pillars and outcomes
CONCLUSION	Assert why the Bank is viable by affirming that High areas of vulnerabilities are identified, tolerance levels can be contained, key staff are in place with evidence.

VIABILITY AND SUSTAINABILITY STATEMENT

Sections 71-73 of The Development Financing Institutions Act(2020) requires the financial statements and accounts on a going concern basis.

In addition, Corporate Governance Disclosure Directive, 2022 and the emerging Viability and Sustainability (Exposure Draft) 2023, require the Directors to make a statement in the Annual Report regarding the viability of the Bank, including an explanation to how they assessed the prospects of the Bank, the period of time and why they consider that period to be appropriate.

VIABILITY AND SUSTAINABILITY

The availability of DBG's Working Capital and Viability framework is expected to give management and Board sufficient viability and confidence on the future operating environment for the time period.

The Draft Exposure recommends a maximum of 3 years. This means that it is the period likely to be covered by the formal projections of profitability, cash flows, capital requirements and capital resources.

VIABILITY AND SUSTAINABILITY

It is also within the period over which regulatory and internal stress testing is carried out.

It is representative of the level of anticipated regulatory change in the financial services industry.

WHAT DIRECTORS SHOULD DO IN THEIR ASSESSMENT PROCESS

Carry out a robust and detailed assessment of the Bank's risk profile and material existing and emerging risks.

Notable among these are risks which senior management believe could cause the Bank's future results of operational or financial conditions to differ materially from current expectations or could adversely impact the Bank's ability to meet regulatory requirements.

Reviewed how these risks are identified, managed and controlled.

Consider the Working Capital Report which provides an assessment of forecast CET 1, leverage, Tier 1 and total capital ratios as well as built up Marginal Eligible Liquidity up to the third year.

WHAT DIRECTORS SHOULD DO IN THEIR ASSESSMENT PROCESS

Reviewed the Bank's liquidity and funding profile, including funding profile including forecasts of the Bank's internal liquidity risk appetite(LRA) and liquidity coverage ratios.

Consider the Bank's viability under specific and regulatory stress scenarios.

Consider the stability of the major markets it operates, supply chain resiliency and regulatory changes.

Consider the sustainability of capital distributions.

WHAT DIRECTORS SHOULD DO IN THEIR ASSESSMENT PROCESS

Consider scenarios which might affect the operational resiliency of the Bank.

Review any draft statutory accounts and the in-depth disclosure of the financial performance of the Bank.

Consider the Bank's medium –term plan.

Review the possible impact of legal, competition and regulatory matters.

WHAT DIRECTORS SHOULD DO IN THEIR ASSESSMENT PROCESS

Evidence of bank-wide stress tests against a severe but plausible near-term climate scenario particularly with respect to agro-business sectors targeted. The aim is to identify key vulnerabilities that are most relevant and material to the Bank's business model and geographical footprints.

WHAT DIRECTORS SHOULD DO IN THEIR ASSESSMENT PROCESS

Legal proceedings, competitors, regulatory and remediation / redress conduct matters should be assessed as part of the stress testing process.

Capital and liquidity risk appetite are ascertained if they reflect the level designed to enable the Bank to withstand various stress scenarios. As part of this process the Board is expected to ascertain if management identified actions including cost reductions, withdrawal from lines of business available to restore the Bank to its desired capital flightpath.

WHAT DIRECTORS SHOULD DO IN THEIR ASSESSMENT PROCESS

Directors are expected to consider PFIs whose businesses point to a potential exposure of the business model to Money Laundering and Terrorist Financing (ML/TF), climate-related risks and risks due to the increasing adoption of financial technologies by Regulated Financial Institutions(RFIs) which include the PFIs.

Enforce the Basel II/III-IV Classification of Banks into three categories –A, B and C using the Standardized Credit Risk Assessment (SCRA) at follows.

STANDARDISED CREDIT RISK ASSESSMENT APPROACH

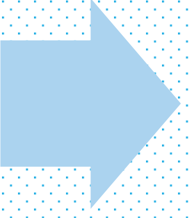
RISK WEIGHT TABLE FOR BANK EXPOSURES			
STANDARDISED CREDIT RISK ASSESSMENT APPROACH			
Credit Risk Assessment of Counterparty	Grade A	Grade B	Grade C
‘’ Base’ risk weight	40%	75%	150%
Risk weight for short – term exposures	20%	50%	150%

STANDARDIZED CREDIT RISK ASSESSMENT

- Under the SCRA, exposures to banks without an external credit rating may receive a risk weight of 30%, provided that the counterparty bank has a Common Equity Tier 1 ratio which meets or exceeds 14% and a Tier 1 leverage ratio which meets or exceeds 5%.
- The counterparty bank must also satisfy all the requirements for Grade A classification.

GRADE A

(CRE 20:22)Grade A refers to exposures to banks, where the counterparty bank has adequate capacity to meet their financial commitments (including repayments of principal and interest) in a timely manner, for the projected life of the assets or exposures and irrespective of the economic cycles and business conditions.



DBG should consider the impact of material climate-related financial risks on the counterparty bank's capacity to meet their financial commitments in a timely manner for the projected life of the bank's assets or exposures to this counterparty bank.

GRADE A

Prudent practice by the bank to evaluate the counterparty bank's ability to repay commitments could include incorporating consideration of material climate-related financial risks into the entire credit life cycle, including client due diligence as part of the onboarding process and ongoing monitoring of clients' risk profiles

GRADE A

(CRE 20: 23) A counterparty bank classified into Grade A must meet or exceed the published minimum regulatory requirements and buffers established by its national supervisor as implemented in the jurisdiction where it is incorporated, except for bank-specific minimum regulatory requirements or buffers that may be imposed through supervisory actions (e.g. via the Supervisory Review Process, SRP) and not made public.

(CRE 20:24)If such minimum regulatory requirements and buffers (other than bank-specific minimum requirements or buffers) are not publicly disclosed or otherwise made available by the counterparty bank, then the counterparty bank must be assessed as Grade B or lower.

GRADE A

If as part of its due diligence, a bank assesses that a counterparty bank does not meet the definition of Grade A in CRE20.22 and CRE20.23, exposures to the counterparty bank must be classified as Grade B or Grade C.

GRADE B

(CRE: 20.25) Grade B refers to exposures to banks, where the counterparty bank is subject to substantial credit risk, such as repayment capacities that are dependent on stable or favourable economic or business conditions.

(CRE: 20.26) A counterparty bank classified into Grade B must meet or exceed the published minimum regulatory requirements (excluding buffers) established by its national supervisor as implemented in the jurisdiction where it is incorporated, except for bank-specific minimum regulatory requirements that may be imposed through supervisory actions (e.g. via the Supervisory Review Process, SRP) and not made public.

If such minimum regulatory requirements are not publicly disclosed or otherwise made available by the counterparty bank then the counterparty bank must be assessed as Grade C.

GRADE C

(CRE: 20.28) Grade C refers to higher credit risk exposures to banks, where the counterparty bank has material default risks and limited margins of safety. For these counterparties, adverse business, financial, or economic conditions are very likely to lead, or have led, to an inability to meet their financial commitments.

(CRE: 20.29) At a minimum, if any of the following triggers is breached, a bank must classify the exposure into Grade C:

(1) The counterparty bank does not meet the criteria for being classified as Grade B with respect to its published minimum regulatory requirements, as set out in CRE20.25 and CRE20.26; or

GRADE C

(2) Where audited financial statements are required, the external auditor has issued an adverse audit opinion or has expressed substantial doubt about the counterparty bank's ability to continue as a going concern in its financial statements or audited reports within the previous 12 months.

Even if the triggers set out in CRE20.29 are not breached, a bank may assess that the counterparty bank meets the definition in CRE20.28. In that case, the exposure to such counterparty bank must be classified into Grade C. 20.30 Exposures to banks with an original maturity of three months or less, as well as exposures to banks that arise from the movement of goods across national borders with an original maturity of six months or less,(this may include on-balance sheet exposures such as loans and off-balance sheet exposures such as self-liquidating trade-related contingent items) can be assigned a risk weight that correspond to the risk weights for short term exposures .

END OF PRESENTATION

FOR YOUR