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An Evaluation into the Impact of the Global Recession on Botswana Building Society (BBS)

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Abstract

The 2008 to 2011 world recession has its roots in the sub-prime crises. The whole banking industry came in to danger with the threat of a total collapse. The banking system in Botswana had however, no direct link to the subprime assets that triggered the crisis in the advanced economies. The direct exposure of banks in this regard was from their clients, mostly companies which depended heavily on foreign clients. Falling demand for Botswana exports in the international markets exerted severe stress on the balance sheets of many local banks. A case study of Botswana Building Society (BBS) was undertaken to investigate the effects of the recession on the bank's operation and the banking sector of Botswana. A qualitative research methodology was adopted and interview questions were developed and employed to collect data from BBS staff members, management and customers to ensure that more detailed information on the effects of the recession has been collected and consolidated. The thematic approach was used to analyse the data from the respondents. The information collected provided the basis for conclusions on the effects of the recession on the performance of BBS. The body of the research draws a conclusion that there was a decline in the performance of the bank, with low customer base and hence low profitability. This decline was mainly due to the effects of the economic recession over the period 2008 to 2011. Therefore, it can be concluded from the empirical findings that there is a negative relationship between the economic recession and BBS performance.

Key Words: *Recession, Banking, Corporate Governance, Financial Crisis, Capital.*

Introduction

A recession is a period of time when a nation's gross domestic product (GDP) declines for at least two consecutive quarters (National Bureau of Economic Research, 2010). A financial sector is described as a part of an overall economy that is primarily made up of money markets, banking institutions and brokers. BBS, as a bank is part of the financial sector which forms the life blood of the Botswanan economy. A case study of BBS was undertaken to investigate the effects of the recession on the bank's operation and the banking sector of Botswana. It is generally understood that economic growth and development of any country depend upon the health of a banking system. The banking system is regarded as the driving engine for the development of every economy. Banks provide loans and capital to the business, industrial and agricultural among other sectors. Loss of profit and capital on the banking sector bring serious threat to the economic well-being of a country. It affects capital and money markets which provide long term and short term lending to the economy.

Research Context and Background

The 2007 to 2011 world recession has its roots in the sub-prime crises. Huge financial institutions provided loans to borrowers who were not eligible for the same. This led to a construction boom with most people getting mortgage loans for building and extension of land and buildings. The problem exacerbated when the second class borrowers failed to pay back the principal amount and the interest charges. The whole banking industry came in to danger with the threat of a total collapse (The Economist, 2013:47).

The banking system in Botswana had however, no direct link to the subprime assets that triggered the crisis in the advanced economies. The direct exposure of banks in this regard was from their clients, mostly companies which depended heavily on foreign clients. These companies include the mining sector, agricultural sector, manufacturing sector, and the tourism industry among others (FinMark Report, 2012:45).

Falling demand for Botswanan exports in the international markets exerted severe stress on the balance sheets of many local banks. The country largely relies on diamond exports. Large off-balance sheet exposures magnified their stress levels further. In this context, it was felt necessary by these companies to retrench their employees to reduce expenditure. Consequently, the employees of the affected sectors formed part of the banking sector clientele base. This led to a spiral decline in performance of the whole banking sector. Some of the banks with exposures to credit derivatives had to book losses on account of widening off credit default swap spread. The exposures were very significant, and banks had not made adequate provision to meet the losses on such exposures (The Economist, 2013:52).

The global financial crisis impact on BBS was for the most part, direct and there was an increase in non-performing loans in the household sector. However, BBS is not extensively exposed to the mining sector (largely financed by foreign parent companies and via retail earnings). It is however significantly exposed to households, who account for approximately 59% percent of bank lending in relation to the private sector which represent about 23% of the total bank assets' (FinMark, Report, 2009:29). However, The Bankers Magazine (2011:44) argues that part of the mining sector's employees had mortgage loans with BBS, thus having a negative bearing on the performance of the building society.

Problem Statement

The problem statement emanates from the slowdown in business activities during the period under review. The economy of Botswana has been greatly affected by the recession and financial crises. Changes in business and consumer behaviour were observed. The general income levels for households and the business sector declined while unemployment increased.

It was during the reporting period that the Botswanan economy struggled under more uncertain conditions related to mounting negative effects of the credit crises. The period saw many customers reducing their deposits in the banks, some closing their bank accounts while others were caught in a debt trap. The level of credit advances were further affected by a civil service strike which took place in April of 2010.

It is against this backdrop of customer demand and business activity that the investigation on the level of impact of BBS can be ascertained. The bank depends on households and the corporate world as its core clients. The effects of the global crises can be reflected through how the bank performed during the crises period.

Aim of the Study

The aim of the study is to evaluate the performance of BBS in the light of changes in the economic environment and its impact on BBS banking and financial services.

Objectives of the Study

The objectives of the study will be to:

1. Determine how the recession has impacted directly on BBS operations over the three year period.
2. Identify and evaluate the key factors affecting the financial performance of BBS over the three year period.
3. Make policy recommendations in improving the bank's performance in a turbulent economic environment.

Research Questions

1. What is the impact of the recession on BBS operations over the three year period?
2. How are the key factors affecting the financial performance of BBS over the three year period identified and evaluated?
3. What policies or strategies can be recommended in improving the bank's performance in a turbulent economic environment?

Significance of the Study

This research is the first of its kind in BBS regarding issues surrounding the effects of economic downturn which have not been previously explored. Through this research it is hoped that BBS would be able to conduct a thorough introspection and draw conclusions as to whether it should adjust its policy framework pertaining to risk management and perceived identity. This will assist in making inferences about the general performance of the financial sector in varying macro-economic environments and how the industry can minimise its negative effects. The management of BBS would also be in a position to identify policy areas where traditional approaches to banking need to be reviewed. This should lead to the repositioning of BBS to conform to broader developments in the banking sector. Consequently the study will set the scene for the sector to conform to good banking practices and guard against future effects of recessionary periods. The findings and conclusions of this report should unequivocally point to the pressing need for BBS to review its operational policy and reform itself towards a sector-corporate banking culture and identity.

Literature Review

Recession

Acharya, Cooley, Richardson and Walter (2010:26) define recession as a business cycle contraction. A cyclical fluctuation in a business cycle has four stages, namely recession, recovery, boom and trough (Marais, 2009:214). Bond (2009:145) states that any form of recession is associated with falling GDP, a fall in the demand of goods and services, decline in investment among other issues.

Impact of Recession in the Banking Sector

The global banking system during the recent economic recession is still a topical issue among the corporate world and households. With regards to the recent recession that began in 2007, Bhaduri (2010:44) indicates that each financial crisis has recurring features that are similar, yet the historical perspective makes each crisis different. The author suggests that the purpose of any theory concerning a recession is to identify specific characteristics, effects of the crises and come up with possible solutions to adequately address a particular crisis. Although formal models are not always historically accurate, at least they provide some insight into the central mechanisms that precipitate many financial crises (Bhaduri, 2010:45).

Bhaduri (2010:52) points to two features that typically recur in a crisis. The first is the loss of confidence in or by the financial sector. Since the system of credit provision is dependent on mutual confidence among the players in the market, any abrupt changes in lenders' behaviour is likely to cause a crisis. The second feature is the transmission of the crisis from the real economy into the financial sector via low deposits and aggregate demand, typically through a sudden decline in real investment.

The Banking Model

The banking model was propounded by Demirguc and Huizinga (2010:32) in explaining the effects of recession on the banking operations. The authors posit that there exists a relationship between a business model and banks performance risk. The banking model is best explained by a number of key factors which include capital, operating efficiency, funding sources, securitisation, links with financial markets and corporate governance. Beltaratti and Stulz (2011:66), explained banks' performance and risk in terms of capital tiers as outlined below:

Capital Tier 1

Capital tier 1, describes banks with stronger capital supervision through regulation and management policy. The banks in capital tier 1, have higher assets to loan ratio, which improves the capital adequacy of the banking operation. The capital adequacy is best explained by the Capital Asset Pricing Model (CAPM). The bank is expected to have a minimum amount of capital to ensure the current and non-current liabilities can be paid given insolvency (Beltaratti and Stulz (2011:66).

The banking model explains that banks with capital tier 1, in countries with stronger capital supervision tend to be stronger even during the recession period. These banks have a higher loan to total assets ratio and are expected to perform better in the initial stage of global crises. Banks with a larger capital base and more liquid assets become associated with higher returns. The banks with tight internal control can sail through a recession with minimal effects on its operational liquidity (Ellu and Yerramilli, 2010:121).

Corporate Governance

Corporate governance is defined as processes by which organisations are directed, controlled, and held to account and it is underpinned by the principles of openness, integrity, and accountability. In essence, corporate governance provides the guidelines as to how a company can be directed or controlled such that it can fulfil its goals and objectives in a manner that adds to the value of the company and is beneficial for all stakeholders in the long term (Arthur, Thompson and John, 2008:79).

The banks with good corporate governance base their operations on principles by conducting business with all integrity and fairness, being transparent with regard to all transactions, making all the necessary disclosures and decisions by complying with all the laws of the land, accountability and responsibility towards the stakeholders and commitment to conducting business in an ethical manner (Arthur et al., 2008:79). These banks were able to stand the recessionary period as they operated within the financial regulation framework. The absence of good institutional governance expose the banks to high risk during the recessionary period resulting in loss of money through the multiplier effect working in the reverse direction.

Operating Efficiency

Operating efficiency is described as minimising the cost of operating by a bank through various measures which are cost effective. Berger and Bouwman (2011:126) emphasize operating efficiency as the high level of productivity of a bank in its day to day operations. Cole and White (2012:289) concurs that the capital base in terms of assets of a bank becomes stronger during the recession, thus lowers the likelihood of the failure rate of the bank.

Capital Structure

The Basel Accord on capital standards played an important regulatory role in the banking system. The general yardstick being the higher the capital reserves of a bank, the greater the buffer to withstand losses. There is also an asset-shifting in terms of riskier assets, and higher level of assets is more conducive to higher screening of borrowers and hence less risk to the bank (Stolz and Wedow, 2010:176).

The authors also emphasize the positive relationship between risk and capital. The agency problem between managers and shareholders also lead to increased leverage which reduces risk by giving pressure on the bank to become more efficient. There is also a positive relationship between the bank and capital when regulators force the bank to build up more capital resulting in greater risk absorption capacity. The model concurs that capital increases the banks soundness during the period of crises and for higher quality.

Asset Size

The assets size of a bank is an important risk factor. The bigger banks with larger capital size have a larger capital base to diversify risk and through securitisation, the bank can offload part of their loans from the asset side of their balance sheet, to financial market investors. The securitisation process allows banks to run into illiquid claims, thereby changing a banks model into incentive claims to hedge and minimise risk (Wu, Yang and Hong, 2011:189).

Methodology

Cresswell (2013:516) concurs that the methodology comprises a set of techniques that researchers use to conduct an enquiry and will provide a set of rules and procedures to guide research against which its claims can be evaluated. The researcher adopted a case study methodology in the light of Yin's (2012:66) description that a case study approach has the ability to analyse a study in its normal environment. The researcher adopted a deductive qualitative approach to the research. The researcher found this approach to be more appropriate as it entails a comprehensive investigation to get an in-depth understanding of the impact of the recession on the financial services sector.

In the current study, the researcher used both the primary and secondary data collection methods, given the fact that both primary and secondary data were needed. In order to have more valid data, there was need for the researcher to obtain information from different departments across the BBS by carrying out in-depth interviews with the respondents.

The researcher adopted a structured interview to guide the participants in the kind of responses the researcher was expecting. The researcher had to ensure that only relevant information was collected, hence the need for structured questions. However, for the sake of an in-depth understanding, additional questions related to the structured questions were asked of the respondents.

The target population in this study was overwhelming for the researcher to collect information and hence the researcher resorted to sampling. The total number of staff members are 800, while customers are estimated at 10 000. The researcher realised that it will be costly and time consuming to target the entire population of BBS staff members and customers to collect information, hence the researcher resorted to sampling.

A judgemental sampling technique was used to select the participants for the interview. A total of fifteen participants were targeted with eight BBS staff members and seven BBS customers. The total participation rate was 100%, with eight BBS staff members and seven BBS customers participating in the study. The responses for BBS staff members were fairly spread over the departments, which imply that the results of this study can be considered as a good representative of BBS staff perception on the effects of the recession.

The researcher worked under the assumption that the data collected through the interview was correct and can be relied upon. In addition, data collected was discussed and analysed in detail. A preliminary interview enabled the study to satisfy the validity and the likely reliability of the data.

The researcher used a qualitative approach by focusing on themes, which are the most common responses or words or opinions expressed by the participants in presenting their views. The field notes collected during the empirical review were summarised and given meanings before the researcher consolidated them. The thematic, category and content analysis was used to present and interpret the findings from the interviews with BBS staff members and its customers.

Result and Discussion

Objective 1: To determine how the recession has impacted directly on BBS operations over the three year period.

The results from the empirical findings about the relationship between the banking industry operations and the effects of recessions were found to be positive and correlating. The theoretical foundations of Bond (2009:145; Marais, 2009:2014) supported that any form of recession is associated with falling GDP, a fall in the demand of goods and services, decline in investment, among other issues.

The results were in line with the empirical findings that there was a negative effect on BBS operations as a result of the impact of the recession. The departments which were mainly affected include Corporate Banking Services, Retail Banking, Creditors Department, Information Technology, and General Administration with the magnitude of effect differing in magnitudes. The participants from the outlined departments concurred in the interviews that demand for their products went down by almost a range of between 60% to 80%.

The empirical findings has the same evidence that there was a sharp decline in the corporate department services as most companies reduced their demand for BBS services. This was mainly due to declining profits that were shrinking during the period. The spiral effects were felt in retail banking as demand for retail products went down in response to decrease in employment levels leading to fewer customers for each department. Hence, the relationship between the recession and BBS operations was perceived as positive as the majority of the participants (75%) concurred that the recession had an impact on BBS operations during the 2008-2011 period.

Objective 2: Identify and evaluate the key factors affecting the financial performance of BBS over the three year period.

There are many factors which affected the operational performance of BBS during the period under review. During the recessionary period, BBS undertook stronger capital supervision through regulation and management policy. The assets to loan ratio was increased in order to improve the capital adequacy of the bank. In addition to that BBS improved the liquidity ratios to ensure that short to medium term obligations could be met.

The initiative was consistent with the banking model as outlined in capital tier 1, which states that stronger capital supervision tends to be stronger during the recessionary period. The resulting model gave BBS a higher loan to total assets ratio to perform better in the stage of global crises. Ellu and Yerramilli

(2010:121) encouraged that the larger capital base provides more liquid assets which are usually associated with higher returns for the bank. The adoption of Ellu and Yerramilli's (2010:122) findings helped BBS to implement tight internal controls, which in turn enabled the bank to sail through the recessionary period with marginal effects on operational liquidity.

Corporate Governance

BBS improved its internal control systems through corporate governance measures by directing, controlling, and holding to account the underpinned principles of openness, integrity, and accountability as described by Arthur, Thompson and John (2008:79).

There was strong surveillance which based its operations on principles of integrity, fairness and transparency thus making all the necessary disclosures and decisions through compliance. The bank was able to withstand the recession as it operated within the financial regulation framework prescribed by the Bank of Botswana.

Operating Efficiency

BBS in adopting the banking model also focused on operational efficiency. This was done to enhance the survival of banks during the recession by minimising cost of operations through cost effective measures. In recent literature, authors who include Berger and Bouwman (2011:126) states that operating efficiency indicates high level of productivity in a bank's day to day operations. In the case of a recession, or banking crises, a recessionary period improves banks' performance as the bank finds ways of minimising operational costs in the face of a slowdown in economic activity. Unfortunately there had to be some retrenchment of workers as a way of reducing BBS operational costs.

Asset Size

The assets size of BBS played an important role in improving its Capital-Adequacy and Liquidity. The larger capital of BBS helped to diversify risk through securitisation, as BBS was able to offload part of their loans from the asset side of their balance sheet, to financial market investors. The securitisation process assisted BBS to run into illiquid claims, by changing banks models into incentive claim to hedge and minimise risk as described by Wu, Yang and Hong (2011:189).

Objective 3: Make policy recommendations in improving the bank's performance in a turbulent economic environment**.**

The following recommendations can be drawn based on the findings of the study:

Top Management Support

BBS has a good organisational structure which need more top management support in implementing the Bank of Botswana's policy framework. The good structure will effectively help in implementing good banking policy, corporate governance measures and Bank of Botswana's surveillance and supervision policies. The ineffective implementation of policies was among the key causes of the decline in the financial performance of BBS during the recession. The failure by management to observe corporate practices, and banking guidelines led to the collapse of the banking systems.

Capital Structure

BBS can improve its capital structure as capital standards plays an important regulatory role in a banking system. The higher the capital reserves the more it buffers to withstand losses mainly due to a recession.

This will also allow asset-shifting in terms of riskier assets, where higher level of assets are more conducive to higher screening of borrowers and hence less risk to the bank (Stolz and Wedow, 2010:176). Moreover, the bank is able to build up more capital resulting in greater risk absorption capacity.

Funding Structure

BBS can also focus on financial innovation by increasing its dependence on financial markets for their funding. This means in case of a recession, BBS can borrow from the wholesale markets, where funds are raised through issues of mortgage, bonds, repo agreements which were insured. As a result, the bank's failure during the recession can be minimised by borrowing from the financial or capital market to cushion the liquidity crises as supported by White, Kim and Mangauelli (2011:233).

Moreover, the stickiness of depositors can lead to high switching costs and transaction services that retailers receive from the bank. The depositors are less flexible in adapting to changes in financial needs and funding investments. BBS can raise interbank market finance with new amounts of funding at low costs.

Training and Workshops

Employees at BBS can be trained on corporate compliance and governance issues. The bank was not properly implementing governance policies and compliance with some of the regulations being enforced by the Bank of Botswana. A well trained staff member will implement good governance policies and avoid the effects of the recession on the bank's operations.

Furthermore there is need for managerial support and consistency in decision making by the Executive Management of BBS to ensure all policies and procedures are adhered to. Management in general should be inducted in governance issues, since they are the initiators who pass the policies down the chain of command.

Conclusion

This study focused on an evaluation into the impact of the global recession on BBS. The study succeeded in highlighting the effects of a recession on BBS and the banking sector in Botswana. Future research can focus on investigating the effects of the recession on commercial banks in Botswana since the operations of commercial banks and building societies differ. There is need to investigate whether the same effects of a recession on building societies can be transferred to commercial banks and come up with a conclusive stand on the effects of the recession in the banking sector.

The findings from the literature and empirical review add to the body of conclusion that there is a positive relationship between BBS performance and recession. The recessionary period between 2008 and 2011 had a bearing on the performance of BBS resulting in low performance and negative effects on its customers. The management of BBS took initiatives to manage the negative effects of the recession.

One group that were really affected by the recession were BBS employees. The management at BBS undertook some reform programmes in reaction to the effects of the recession on the banking activities. This was in response to a decline in profitability, due to lower operational activities in the bank. In response to this, some employees were laid off, whilst others had their salaries frozen as the bank attempted to reduce operational costs in line with declining profitability during the period. Therefore, the conclusion based on the literature and empirics concurs that the recession had a negative effect on the banking sector.

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