BANK OF UGANDA

37/45 KAMPALA ROAD, P.O. BOX 7120, KAMPALA
Telephone: 256-414-258441/6, 258061, 0312 392000, 0417 302000. Telex: 61069/61344;
Fax: 256-414-233818, Website: www.bou.or.ug**; Email address:** info@bou.or.ug

Quarterly Financial Stability Review

June 2021

The operating environment for the banking sector remains challenging and the outlook is for this scenario to continue until economic recovery is stronger. The main risks to financial system stability include uncertainty about the pace of economic recovery, the disruptive resurgence of the pandemic during June and July 2021 which is expected to increase credit risk especially in sectors that remain under prolonged lockdown, the potential rise in non-performing loans to levels that may threaten financial stability after the expiry of the Covid-19 Credit Relief Measures (CRM) in September 2021, and the potential reversal of capital flows as advanced economies normalize their monetary policy which may adversely affect market risk. Assessments by BOU indicate that on aggregate the banking sector remains sound and is resilient to the aforementioned potential shocks with strong liquidity and capital buffers supported by BOU policy measures. Nevertheless, Supervised Financial Institutions (SFIs) need to proactively build further resilience.

1. The Macro-Financial Environment

Global growth prospects remain strong. The International Monetary Fund (IMF) projects that the global economy will grow by 6.0 percent in 2021 and moderate to 4.4 percent in 2022, recovering from the 3.3 percent contraction in 2020. The improved economic outlook is likely to support the financial performance of the Ugandan export sector. However, notable downside risks to future GDP growth remain, and particularly, economic prospects have diverged further across countries since April 2021, influenced by differential access to COVID-19 vaccines, with most emerging economies on the negative side of this outturn.[1]

Following the easing of the first lockdown measures in June 2020 and supported by accommodative fiscal and monetary policies, domestic real GDP growth picked up to 1.6 percent growth in the quarter ended December 2020 and 6.2 percent in March 2021, but this momentum was interrupted by the slowdown in business activity arising from the necessary lockdown measures in June and July 2021. The growth momentum that was recorded before the second lockdown supported improvement in the performance of the financial sector, however, the disruptive resurgence of the pandemic is likely to result in potentially adverse implications for the financial health of the firms and households, with adverse implications for SFIs, in the short term.

Uganda, like most emerging economies, faces potential risks from the reversal of foreign capital inflows as the advanced economies normalize their monetary policy in response to inflation expectations. The resulting tightening of global financial conditions may increase market risk and liquidity risk in the banking sector. In order to effectively mitigate the aforementioned risks, BOU continues to strengthen the monitoring of offshore capital flows on an ongoing basis, and to maintain strong foreign reserves. Foreign reserves have recently been further reinforced by the IMF's allocation of the equivalent of US$345 million in Special Drawing Rights.

Overall, the outlook for Uganda's economic growth remains highly uncertain and is highly conditional on availability of vaccines and the balance between containment measures and economic recovery.

[1] *IMF World Economic Outlook Update, July 2021*

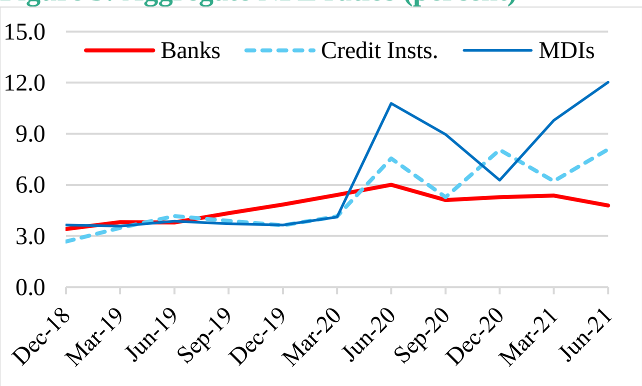
Economic growth is expected to strengthen as the roll out of vaccines increases amidst increased public investment, improved credit growth and stronger global recovery, which will support banking sector performance. BOU policy measures, including the accommodative monetary, stance are expected to support this growth trajectory.**Error! Bookmark not defined.**

2. Performance of Banking Institutions

2.1. Lending activity and credit risk

Credit risk remains elevated but was relatively contained by the BOU credit relief measures. The uneven and slow economic recovery continues to weigh down borrowers' capacity to meet loan obligations. The aggregate commercial banks' ratio of non-performing loans–to–total loans (NPL ratio) reduced from 5.4 percent in March 2021 to 4.8 percent in June 2021, while the NPL ratio for Microfinance Deposit-taking Institutions (MDIs) and Credit Institutions (CIs) deteriorated to 12.0 percent and 8.1 percent in June 2021. By sector, the largest NPL ratios were seen in the Trade, Real estate, Personal & Household loans, Agriculture, and Manufacturing sectors, with 6.7 percent, 6.2 percent, 4.2 percent, 4.2 percent, and 2.1 percent respectively.

Figure 3: Aggregate NPL ratios (percent)



***Source:** BOU*

Aggregate NPLs are projected to increase in the near term, on account of the disruption in economic activity from the resurgence of the pandemic, the expiry of the CRM program, and the effect of delayed payment of Government arrears[2] on some borrowers. In particular, loans under credit relief that are past due by at least one installment **rose** to USh.1.48 trillion (44.3 percent of total restructured loans and 8.4 percent of industry gross loans), from USh.1.07 trillion in March 2021. However, on a positive note, banks took action to address credit risk, by prudently writing-off bad loans amounting to USh.126.1 billion during the quarter and increasing aggregate specific provisions by 6.9 percent from USh.404.9 billion in June 2020 to USh.432.9 billion as at end June 2021. Nonetheless, SFIs need to continue proactive and prudent provisioning.

Credit growth moderated, reflecting a combination of factors. These include subdued credit demand on account of low level of economic activity, government's high financing needs, and reduced supply of credit. SFIs' risk appetite for private sector lending remains weighed down by concerns about potential deterioration in asset quality and impaired borrowers' creditworthiness. SFIs' gross loans and advances grew by 1.2 percent to USh.17.65 trillion over the quarter ended June 2021, compared to 0.8 percent growth in March 2021. By sector, credit growth was dominated by manufacturing (by 2.0 percent); building, construction, and real estate (by 3.2 percent); and personal and household loans (by 4.3 percent). On the other hand, growth in lending to community and social services (which includes education services) was *minus* 2.6 percent. The moderation in lending is expected to continue in the near term on account of slow economic activity induced by the pandemic, with knock-on effects on the performance of SFIs, but is projected to be stronger in the medium term as the economy is fully reopened.

Box 1: Performance of the BOU Covid-19 Credit Relief Measures (CRM)

The BOU Credit Relief Measures (CRM) program is on course to end on 30th September 2021.

[2] *The Financial Stability Review for the quarter ended March 2021 presented results of a BOU survey that found that the total exposure of SFIs to borrowers with exposure to Government arrears as at end March 2021 was USh.888.6 billion.*

The CRM program, which was instituted in April 2020 as a short-term measure, has performed as intended and met its objectives by supporting financial institutions and borrowers to weather the adverse impact of the pandemic and alleviate risks to financial stability. Cumulatively, from April 2020 to June 2021, the total credit relief that borrowers applied for amounted to USh.7.4 trillion, of which USh.7.0 trillion (39.9 percent of the banking sector gross loans) was granted by the SFIs. Following resumption of payment by borrowers, the loans still under credit relief have reduced from a peak of USh.5.2 trillion in September 2020 to USh.3.3 trillion (19.1 percent of the industry gross loans) in June 2021. Prolonged use of credit relief, which will have been in place for eighteen months by 30th September 2021, could lead to distortionary effects on the banking sector, result in unsustainable debt levels or distort incentives for loan repayment.

At this point, the key policy challenge involves the need to effectively manage risks related to the end of Credit Relief Measures and to mitigate credit risk for sectors that remain under prolonged lockdown. In this regard:

- BOU shall continue to, on a case-by-case basis, explore policy interventions for those sectors that remain under lockdown.
- The main downside risk to ending the CRM is the potential rise in NPLs amidst the low economic activity, whereby BOU projections show that the industry NPL ratio could deteriorate to 12.5 percent by December 2021. However, BOU stress test results show that most SFIs, including all the Domestic Systemically Important Banks (DSIBs), have strong capital buffers to absorb the impact of the potential rise in NPLs in the near-term.
- BOU continues to engage SFIs that face a combination of a high exposure to restructured loans as well as marginal liquidity and capital ratios, and are thus likely to face challenges as the credit relief measures expire.
- In addition, BOU shall embark on a countrywide public engagement program during quarter of July-September 2021 through radio talk shows, print media and meetings, to ensure that all eligible cohorts of borrowers, including those that were adversely affected by the lockdown of June and July 2021, solicit and benefit from for 2nd and 3rd restructuring by the end of the CRM program, if they qualify for it. During the exercise BOU staff will also engage SFIs to ensure that they continue to provide credit relief to eligible borrowers before the CRM expire on 30th September 2021, and that they take steps to recognize and provide for bad loans in a timely manner in order to reduce overall emerging credit risk.
- The accrual of interest on restructured loans has resulted in some SFIs facing higher loan exposure relative to the value of the underlying collateral. SFIs are expected to set aside provisions for any exposure that is above the Loan to Value limit (see Box 2).

Box 2: LTV Limit to minimize Credit Risk

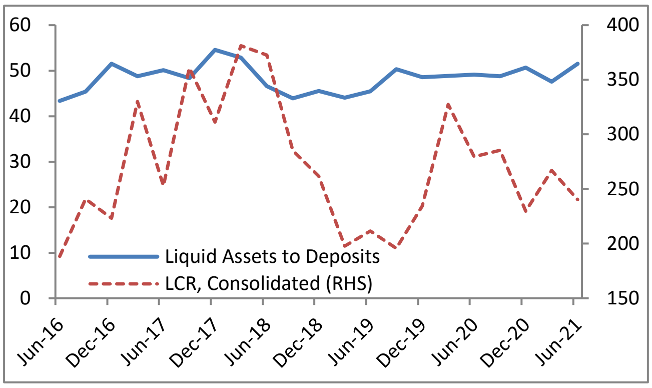
In August 2021, BOU maintained the prudential **Loan-to-value (LTV) limit of 85.0 percent** on new loans to residential mortgages and land purchase remains in place, as a measure to minimize potential build-up of excessive leverage.

2.2. Funding and liquidity

Liquidity risk remains low. Liquidity conditions improved in the quarter to June 2021, **supported by** continued growth in customer deposits and SFIs' investment in Government securities (liquid assets). The cost of both retail and wholesale funding also reduced, thereby enhancing resilience to potential liquidity shocks. Customer deposits, which are the main sources of funding for banks, increased by 3.2 percent over the quarter to June 2021, higher than the 0.2 percent growth in the preceding quarter, while the banks' aggregate cost of deposit reduced from 2.43 percent in March 2021 to 2.35 percent in June 2021.

The aggregate **Liquidity Coverage Ratio (LCR),** which measures the ability of SFIs to withstand a 30-day liquidity stress period stood at 240.3 percent as at end June 2021, and was well above the regulatory minimum of 100 percent. In addition, the aggregate **liquid assets-to-deposit ratio** stood at 51.5 percent, well above the regulatory minimum of 20 percent (Figure 1).

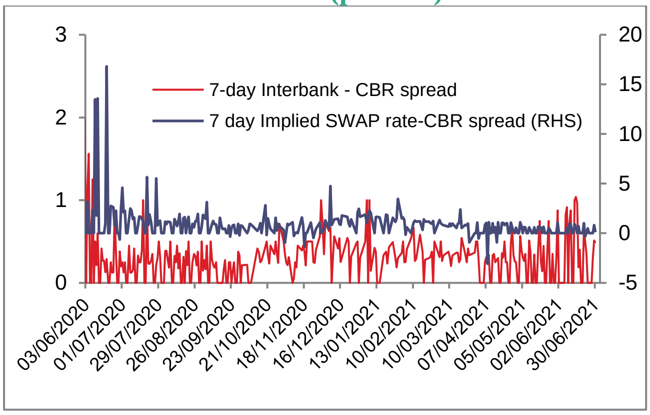
Figure 1: Liquidity indicators, for commercial banks (percent)



Source: *BOU*

In terms of wholesale funding conditions, the cost and volatility in both the interbank and swap market rates, as well as the spread between the markets' rates and the central bank rate (CBR), remained low, compared to a year ago (Figure 2).

Figure 2: Spreads between interbank market rates and the central bank rate (percent)



Source: *BOU*

On the downside, SFI's resilience to liquidity risk could be weighed down by the potential increase of non-performing loans (NPLs) and provisions, adverse impact of delayed payment of government arrears, lingering effects of the pandemic, and market volatility from tighter global financial conditions. Therefore, SFIs need to continue building liquidity buffers and maintain credible liquidity contingency plans.

Box 3: BOU Liquidity Risk Measures

- **The BOU Covid-19 Liquidity Assistance Program (CLAP)** remains in place, to support any SFIs that may come under liquidity stress. During the quarter ending June 2021, none of the SFIs accessed the facility, indicating an improvement in market liquidity conditions.
- **The Emergency Liquidity Assistance (ELA)** is on course to be operationalized in the quarter to September 2021, through which commercial banks, credit institutions and MDIs may access liquidity support under the Lender of Last Resort (LoLR).
- **BOU also embarked on revising the Financial Institutions (Liquidity) Regulations.** The implementation of the regulations will enhance liquidity risk management, align liquidity management with International standards (Basel III framework) and prescribe the Deposit Auction Facility as a liquid asset.

2.3. Capital and profitability

The SFIs' capital buffers remain strong, boosted by increased profits, and higher retained earnings resulting from the BOU restrictions on dividend distributions. The aggregate Commercial Banks', Credit Institutions', and MDIs' core capital-to-risk-weighted assets (RWA) ratio stood at 22.1 percent, 15.6 percent, and 38.2 percent as at the end June 2021, compared to 22.2 percent, 16.9 percent, and 38.5 percent in March 2021, respectively. The majority of SFIs were well above the regulatory minimum requirement of 10.0 percent, 10.0 percent, and 15.0 percent respectively.

The commercial banks' aggregate net profit after-tax (NPAT) increased by 17.5 percent, to USh.1.0 trillion for the year ended June 2021 from USh.853.8 billion over the previous year, with more of the earnings retained to boost capital buffers, partly due to the BOU's restriction on dividend distributions. The increase in profit was largely driven by an increase in interest income from Government securities. The CIs and MDIs posted aggregate net losses of USh.13.3 billion and USh.8.4 billion for the year ended June 2021, respectively. Generally, SFIs' profitability was affected by significant increases in prudent provisioning for bad debts.

Box 4: BOU Capital Adequacy Measures

a) **Payment of Dividends and Other Distributions: The restriction on dividend distributions remains in effect** to support SFIs in building strong capital buffers to cushion against potential losses due to the evolving impact of the pandemic. For the year ending December 2020, nine (9) banks and one (1) MDI proposed to pay dividends amounting to USh.285.5 billion, but BOU is yet to approve the said payments. Going forward, SFIs must continue to submit satisfactory forward-looking Internal Capital Adequacy Assessments Process (ICAAP), in order to justify proposals for dividend payments.

b) **Basel II Basel III:** Full implementation of Basel II remains on course for 1st January 2022. The guidelines for the assessment of credit and operational risk, stress testing, ICAAP as well as guidelines for the computation of minimum capital requirements were issued to the sector in July 2021. In addition, the Basel III Capital Conservation Buffer (CCB) and Systemic Risk Buffer (DSIBs) requirements for commercial banks and credit institutions are on course to be fully phased in by 31st December 2021.

c) **An Early Warning and Intervention System (EWIS) framework has been completed.** The framework enables adequate lead time to develop and implement appropriate supervisory/regulatory measures to identified emerging stress events within SFIs and the wider banking sector.

2.4. Structural risk

From a structural perspective, banking sector concentration remains high. Five banks, which are also designated as DSIBs, jointly accounted for 69.9 percent of industry profit for the year ended June 2021, and 61.0 percent of total assets as at end June 2021. In order to mitigate the risks posed by these institutions, BOU continued regulatory actions to ensure that all the DSIBs adhere to higher regulatory capital and supervisory requirements in the quarter ended June 2021, including the systemic risk capital buffer.

2.5. Performance of Payment systems, Operational risk and Crisis Management

The June 2021 lockdown disrupted SFIs operations. However, the impact was minimized by remote-working policies and operational capabilities that SFIs had developed following the first lockdown in 2020. In addition, the increased availability of alternative channels for delivery of financial services including internet and mobile banking platforms, allowed SFIs to continue serving customers with minimal interruption.

All systemically important payment systems (SIPs) – *the Uganda National Interbank Settlement System (UNISS, the RTGS system), the Central Securities Depository (CSD) and the Automated Clearing House (ACH)* – operated without significant disruptions during the quarter ended June 2021.

Relatedly, the usage of digital platforms for payments and financial services continued to rise during the year ended June 2021, due to on-going initiatives to improve financial inclusion and operational efficiency during the pandemic. On an annual basis, the value of transactions processed through UNISS and EFT increased by 23.1 percent to USh.487.5 trillion and 16.6 percent to USh.37.0 trillion, respectively. In addition, the value of transactions processed through mobile money platforms rose by 42.2 percent to USh.113.4 trillion for the year ended June 2021. Table 1 below provides more details.

Table 1: Digital payment platform transactions

Platform	Indicator	Year to Jun-20	Year to Jun-21	% Change
Debit cards	Active cards (millions)	2.4	2.7	14.4
	Value of payments (USh. billion)	886.7	1,561.1	76.1
Credit cards	Active cards	10,004	10,719	7.1
	Value of payments (USh. billion)	67.5	41.3	-38.8
Points of sale	Volume (million)	2.5	3.4	35.3
	Value (USh. billion)	555.9	837.6	50.7

Platform	Indicator	Year to Jun-20	Year to Jun-21	% Change
Internet banking	Active users	764,533	849,327	11.1
	Value of fund transfers (USh. trillion)	32.7	39.0	19.4
Mobile banking	Active users (million)	1.1	1.4	28.6
	Value of fund transfers (USh. trillion)	2.8	2.4	-15.6
Mobile Money	Value of fund transfers (USh. trillion)	79.8	113.4	42.2
	Escrow account balances (USh. Billion)	960.2	1,134.8	18.2

Source: *BOU*

In order to enhance the mitigation of operational risks related to payment systems, BOU published on its website the Financial Markets Infrastructure (FMI) Oversight Framework in June 2021. The framework, which is based on the Basel Committee on Payments and Market Infrastructures (CPMI) principles, lays out BOU's oversight objectives, methodology and overall approach to assessing risks in FMIs. The framework will enhance identification and mitigation of potential operational risks in payment systems, and promote the safety and efficiency of Uganda's payment systems.

In addition, BOU in conjunction with other financial sector Regulatory Agencies and the Ministry of Finance, Planning and Economic Development, under the Financial Sector Stability Forum (FSSF), is working with Technical Assistance from the Toronto Centre to prepare a sector-wide Financial Crisis Management Plan. This plan, once completed in early 2022, will enhance capacity and inter-agency coordination, to mitigate potential systemic risks, in the event of a systemic crisis.

3. Summary of Systemic Risks

The dashboard in Table 2 summarizes the key drivers of systemic risks to Uganda's banking sector as at end June 2021. Overall, the risks to financial stability remain elevated largely due to the impact of the uneven and slow economic growth, but remain relatively contained by BOU policy measures.

Table 2: Direction of systemic risk in the quarter ended June-2021

Risk category	Risk direction from previous quarter
Overall risk	↑
Macro risk	↑
Credit risk	↑
Liquidity risk	→
Market risk	↓
Operational risk	↑
Profitability & solvency	→
Structural/concentration risk	↑

Source: *BOU*

4. Outlook and risks for Financial Stability

The outlook for systemic risks in the Ugandan financial system remains highly uncertain. Near-term aggregate risks to financial stability are likely to remain elevated and the SFIs' operating environment is likely to remain challenging, until economic activity picks up.

The performance of SFIs is highly conditional on the availability of vaccines which will enable all sectors to reopen and support the recovery of the financial health of firms and households, as well as stronger global economic growth. On the downside, other key risks include the potential increase in non-performing loans as the credit relief program expires and the potential reversal of foreign financial flows.

BOU remains mindful of the evolution of the adverse effects of the pandemic and stands ready to review the macroprudential policy measures highlighted in this *Report* and to take other appropriate measures as the pandemic evolves, in order to safeguard the stability of the financial system.

5. APPENDIX

5.1 Selected financial soundness indicators for Commercial Banks

	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21
Capital Adequacy (%)					
Total capital/RWA (percent)	22.70	22.51	22.15	23.79	23.53
Core capital/ RWA (percent)	21.07	20.89	20.55	22.22	22.06
NPLs less specific provisions–to–capital	11.16	8.86	9.22	8.32	7.39
Leverage ratio	11.61	11.28	10.95	11.95	11.53
Asset quality (%)					
NPLs to total gross loans	6.01	5.15	5.27	5.38	4.79
NPLs to total deposits	3.66	3.11	3.21	3.29	2.86
Specific provisions to NPLs	39.07	43.46	44.99	47.26	47.31
Earning assets to total assets	67.43	69.83	69.14	69.09	69.70
Profitability (%)					
Return on assets	2.58	2.58	2.38	2.53	2.65
Return on equity	15.24	15.12	14.25	14.72	15.48
Net interest margin	10.89	10.45	10.24	10.42	10.17
Yield on advances	15.53	15.24	14.54	14.58	14.18
Cost of deposits	2.46	2.47	2.43	2.43	2.35
Cost–to–income	74.26	74.26	75.08	73.52	71.74
Liquidity (%)					
Liquid assets–to–total deposits	49.14	48.77	50.65	47.58	51.55
Liquid assets–to–total assets	34.94	34.34	35.41	33.30	35.88
Interbank borrowings to total deposits	1.87	2.46	2.14	2.92	2.59
Market Sensitivity (%)					
Forex exposure to regulatory tier 1 capital	-6.92	-7.48	-5.99	5.51	-6.57
Forex loans–to–forex deposits	62.67	62.15	62.15	62.32	59.24
Forex assets–to–forex liabilities	98.15	95.65	99.43	94.28	93.55

Source: *BOU*

5.2 Selected financial soundness indicators for Credit Institutions

	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21
Capital Adequacy					
Core capital/RWA (percent)	22.8	20.8	16.1	16.9	15.6
Total capital/RWA (percent)	24.0	22.0	17.3	18.1	16.8
Provisions (specific) –to–core capital (percent)	8.3	9.5	18.9	17.2	18.9
Asset Quality					
Total provisions (USh. billion)	18.5	19.8	28.4	28.6	30.8
Non-performing loans (USh. billion)	42.0	30.8	49.1	39.0	54.1
Non-performing loans-to-total loans (percent)	7.6	5.3	8.1	6.2	8.1
Profitability					
Profit/loss (USh. billion)	-0.8	-6.7	-8.7	-11.4	-13.3
Return on Assets (ROA)	-0.1	-0.7	-0.8	0.5	-1.3
Return on Equity (ROE)	-0.5	-3.9	-5.4	2.9	-7.7
Liquidity					
Total public deposits (USh. billion)	550.8	553.6	593.7	671.7	687.0
Liquid assets–to–deposits (percent)	57.1	57.0	59.2	62.4	53.7
Loans–to–deposits (percent)	97.0	101.9	96.8	88.8	92.4

Source: *BOU*

5.3 Selected financial soundness indicators for Microfinance Deposit-Taking Institutions (MDIs)

Indicator	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21
Capital Adequacy					
Core capital/RWA (percent)	36.6	35.9	35.4	38.5	38.2
Total capital/ RWA (percent)	39.4	38.6	38.1	41.3	41.0
Specific provisions–to–core capital (percent)	15.5	8.9	9.0	11.3	17.6
Asset Quality					
Total provisions (USh. billion)	30.8	20.7	20.8	25.9	36.9
Non-performing loans (USh. billion)	40.6	36.4	25.7	38.5	47.2
Non-performing loans–to–total loans (percent)	10.8	9.0	6.3	9.8	12.0
Provisions–to–Non-performing loans (percent)	75.9	56.8	80.9	67.4	78.1
Profitability					
Profit/loss (year to date) (USh. billion)	-4.8	13.8	19.8	-1.3	-8.4
Return on Assets (YTD, Annualized) (percent)	-1.4	2.6	2.7	-0.7	-2.3
Return on Equity (YTD, Annualized) (percent)	-4.7	9.3	10.0	-2.3	-7.9
Liquidity					
Total deposits (USh. billion)	325.1	357.9	355.9	343.6	349.2
Liquid assets–to–deposits (percent)	34.1	32.7	32.9	76.1	73.9
Liquid assets–to–total assets (percent)	70.9	67.1	68.8	35.7	36.2
Loans–to–deposits (percent)	79.6	76.8	74.9	76.1	72.7

Source: *BOU*