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Quarterly Financial Stability Review

September 2021

Uganda's banking system remains resilient to most plausible risks. Economic activity is gradually normalizing after the second wave of the pandemic. Risks to financial sector stability outlook, however, remain tilted to the downside, including potential weaker than expected global growth due to supply chain disruptions and resurgence of the COVID-19 pandemic, as well as the projected rise in credit risk after the expiry of the Credit Relief Measures on 30th September 2021. The systemic risk capital buffer for Systemically Important Banks and the capital conservation buffer, which will take effect from 1st January 2022, as well as the prudential policy of restricting dividend payments, are expected to support banking institutions to build stronger capital buffers against Excepted Credit Losses. Bank of Uganda (BOU) also plans to undertake a system-wide Bottom-Up Stress Test during December 2021 – March 2022, in order to assess the capacity of banking institutions to absorb losses from a potential worsening macro-financial scenario, the results of which will inform further policy action.

1. The Macro-Financial Environment

Although the resurgence of the Covid-19 pandemic has clouded the near term outlook, global economic growth is expected to remain on course, and thereby support the financial performance of bank clientele involved in international trade. Global growth projection was revised downwards[1] to 5.9 percent, 0.1 percentage points lower relative to the previous forecast of July 2021. The key risks to the growth outlook consist of the persistent supply chains disruptions which could spill over into the domestic industrial sector, rising inflationary pressures, and the effect of the containment measures for the COVID-19 Omicron variant which could drag down growth especially for the domestic contact intensive sectors such as hospitality and tourism.

On the domestic scene, high frequency economic indicators suggest that the first half of 2021 showed signs of strong recovery and economic activity is gradually normalizing after the second wave of the pandemic in June/July 2021. Nevertheless, the associated necessary lockdown measures had adverse implications for the banking sector performance and private sector credit growth as illustrated in Section 2. While the resurgence of the pandemic implies that the outlook remains uncertain, the full opening of the economy in 2022, as currently being projected, is expected to spur economic activity and enhance the performance of the banking system.

Bank of Uganda (BOU) also continues to monitor potential risks from the normalisation of advanced economies' monetary policy which was highlighted in the last *Quarterly Report*, and if it were to occur, would result in tightened financing conditions, with implications for banks' market and liquidity risk. Thus far, Uganda has not experienced significant exit of offshore investor funds, nor the attendant shilling depreciation pressure.

The BOU continues to maintain a prudent reserves policy in order to mitigate the abovementioned risk, as well as an accommodative monetary policy support, with central bank rate (CBR) at 6.5 percent since June 2021, in order to support economic growth.

[1] *International Monetary Fund (IMF): World Economic Outlook Report, October 2021*

2. Performance of Banking Institutions

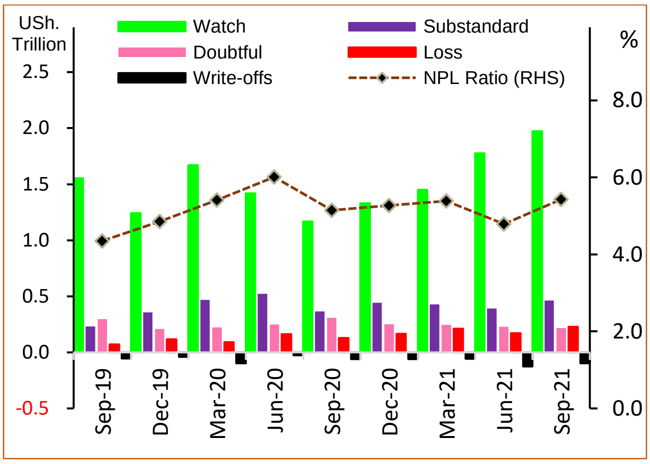
2.1. Lending activity and credit risk

Credit risk remains elevated but relatively contained by BOU policy actions. Loan growth remains subdued, as supervised financial institutions (SFIs)[2] and customers remain concerned about the pace of economic recovery as well as asset quality. Commercial banks' gross loans and advances grew by 1.3 percent to Ush.16.8 trillion over the quarter ended September 2021, marginally up compared to the 0.9 percent growth in June 2021. On an annual basis, the gross loans and advances increased by 7.0 percent in September 2021, slower than the 13.5 percent growth in September 2020. Comparatively, banks' holdings in Government of Uganda treasury securities rose by 31.1 percent to Ush.10.7 trillion over the year to September 2021.

The BOU Credit Relief Measures, which had been in place for eighteen months from 1st April 2020, expired on 30th September 2021. The program successfully moderated the impact of the pandemic on asset quality. The aggregate non-performing loans–to–gross loans (NPL) ratio for commercial banks increased from 4.8 percent in June 2021 to 5.4 percent in September 2021 (but lower than the peak of 6.1 in June 2020). Banks also prudently wrote-off Ush.97.8 billion in bad loans, during the quarter. The aggregate NPL ratio for credit institutions (CIs) and microfinance deposit-taking institutions (MDIs) also increased from 8.1 percent and 12.0 percent to 8.7 percent and 17.4 percent over the same period, respectively.

The cumulative total credit relief that was granted/approved by SFIs between 01st April 2020 and 30th September 2021 amounted to UGX 7.09 trillion, out of the total applications valued at UGX 7.53 trillion. This means that as at 30th September 2021, 40.1 percent of the loan portfolio in the banking sector benefited from the credit relief measures, with SFIs approving 94.2 percent of all applications on average. After peaking at 31.7 percent of total loans in June 2020, the stock of restructured loans reduced to Ush 3.6 trillion (or 19.8 percent of total loans) as of end September 2021, as economic activity normalized following the easing of lockdown measures. However, the restructured loans in default by at least one instalment remain high at USh.1.1 trillion (5.6 percent of gross loans) in September 2021. Stress tests by BOU indicate that most banks have adequate capital to absorb the related losses.

Figure 1: Commercial banks' aggregate NPLs



Source: *BOU*

A related risk arises from the continued slump in real estate prices, which could increase banks' expected credit losses, as most of lending is collateralized with real estate property. Residential real estate prices in Greater Kampala Metropolitan Area reduced by 10.7 percent over the year to September 2021[3], while demand for office space in Kampala remains subdued. In response to this risk, BOU maintained the Loan to Value (LTV) ratio of 85 percent on residential mortgages and land purchase, and indicators show that on aggregate banks have complied with the prudential measure. The outlook for real estate prices remains uncertain, however, the LTV policy is expected to effectively mitigate the exposure of banks to potential risks from reduction in real estate collateral values.

Going forward, c**redit risk is likely to increase mainly due to the prospects of an increase in Expected Credit Losses, amidst the expiry of the Credit Relief Measures.** Moreover, the trend in loans categorized as *'watch'* suggests that NPLs are likely to increase further in the near-term. Secondly, concerns remain over the exposure of the banking

[2] SFIs under the jurisdiction of BOU: Commercial Banks, Credit Institutions, and Microfinance Deposit-taking Institutions.

[3] Uganda Bureau of Statistics: ***Residential Property Price Index report***, September 2021.

sector to sectors that remain under prolonged lockdown, including the Education and Hospitality sectors. As a remedy, on 1st November 2021, BOU announced targeted credit relief for both sectors for a further 12 months to 30th September 2022 (Box 1).

Box 1: Credit Relief Measures for the Education and Hospitality Sectors to 30th September 2022

On 1st November 2021, BOU extended targeted CRM for the Education and Hospitality Sectors for 12 months ending 30th September 2022, cognizant of the impact of the prolonged lockdown measures on both sectors. Under the program, BOU gave all SFIs under its jurisdiction, exceptional permission to provide a repayment credit relief to borrowers in the Education and Hospitality Sectors, at their discretion, that continue to be negatively affected by the Covid-19 pandemic. The following Guidelines shall apply in implementing the targeted CRM.

a) In the 12 months to 30th September 2022, SFIs are permitted to grant one restructuring to credit exposures in the Education and Hospitality Sectors that were granted before 1st April 2020 and were not classified as Loss as of that date, and continue to be adversely affected by the pandemic. The eligible credit exposures are those reported under respective sub-sectors, as well as staff loans to the said sectors, in the BS100 and MDI100 Forms.

b) The duration of any credit relief so granted shall expire on or before 30th September 2022.

c) The restructuring may be in the form of a repayment moratorium, extension of tenor, reduction of principle loan repayment instalment, reduction of applicable interest rate, or a combination of the above.

d) The event of any restructuring granted will not be treated as an adverse change in the credit risk profile of the borrower for reporting to the Credit Reference Bureau nor will it affect the credit classification status or lead to a downgrade of such a credit facility, for the duration of the CRMs.

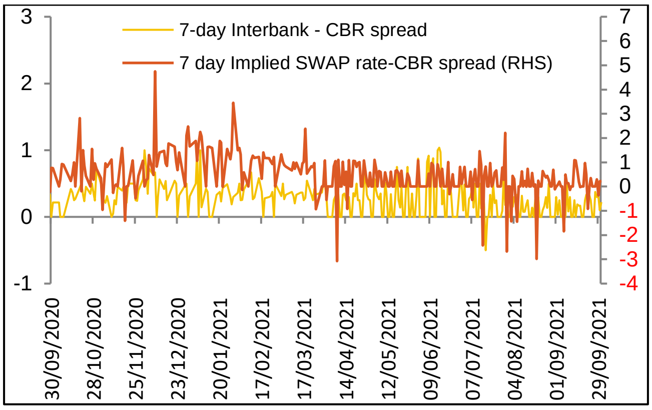
e) This targeted forbearance shall however strictly be subject to the SFIs stopping (not postponing) accrual of interest and compounding of interest on the said loans for the duration that the facility is under credit relief. In addition, SFIs will be required to waive penalties for late payment and fees for early redemption for these loan facilities during the period that they are under this extended credit relief.

f) Consumer protection must be prioritized and SFIs must ensure full disclosure of the terms and conditions of the restructured credit facility. SFIs are required to maintain records of such credit exposures in a format that can be verified by BOU and should also obtain the borrower's consent in writing.

2.2. Funding and Liquidity

Liquidity risk remains low as funding conditions remained stable, supported by BOU's policy measures which include the Standing Liquidity Facility (SLF) and Covid-19 Liquidity Assistance Program (CLAP).

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

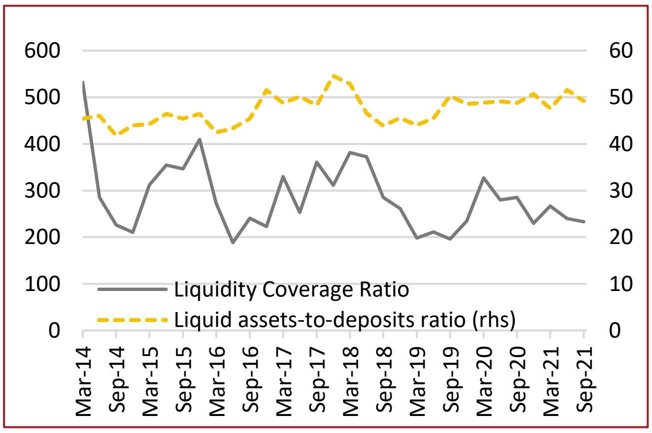


Source: *BOU*

Customer deposits remain the main source of stable funding for the banks and constituted 84.7 percent of total liabilities, while the aggregate cost of these deposits remained low, at 2.36 percent, in the quarter under review. Similarly, the cost of wholesale funding – from the interbank and swap markets – reduced, indicative of reduced perceived counterparty risk. The average spread between 7-day interbank rate and the Central Bank Rate (CBR) and the spread between the 7-day swap and the CBR reduced from 45 basis points (bps) and 55 bps in June 2021 to 25 bps and 15 bps in the quartered ended September 2021, respectively (Figure 2).

SFIs hold strong liquidity buffers, supported by increased holding of Government Treasury securities which rose by 7.4 percent or Ush.753.8 billion in the period to October 2021, amidst aversion to private sector lending. The aggregate Liquidity Coverage Ratio (LCR), which measures the SFIs' ability to withstand a 30-day liquidity stress period using their high-quality liquid assets (HQLA) holdings to meet net cash outflows, was 232.9 percent as at end of September 2021, which was well above the minimum requirement of 100 percent. Similarly, the industry liquid assets-to-deposit ratio stood at 49.2 percent, well above the regulatory minimum of 20 percent.

Figure 3: Banks' aggregate Liquidity indicators (percent)



Source: *BOU*

Box 2: Status of Measures to Enhance Liquidity Risk Management

- **BOU Liquidity Programs:** In November 2021, BOU approved to maintain the Covid-19 Liquidity Assistance Program (CLAP), to support any SFIs that may come under liquidity stress, especially following the end of the broad credit relief measures program in September 2021. However, none of the SFIs used the CLAP in the quarter ended September 2021, as market funding conditions remain accommodative and liquidity risk remains low.

- **The Emergency Liquidity Assistance (ELA),** is planned for implementation effective 1st January 2022, to provide liquidity support for SFIs in distress that may require funds for a longer tenor. In October 2021, BOU conducted consultations with SFIs about the ELA framework, and developed Rules for SFIs to apply for ELA.

- **The draft Financial Institutions (Liquidity) Regulations:** In November 2021, BOU issued the revised draft liquidity Regulations to the SFIs for comments, after which the regulations shall be forwarded to the First Parliamentary Council for final drafting. The implementation of the regulations will enhance SFIs' liquidity risk management, in alignment with International standards (Basel III framework).

2.3. Capital and profitability

In light of the projected direction for macro and credit risks, strengthening capital buffers remains a key priority. SFIs' capital buffers remain strong, which has enhanced their resilience to potential shocks, shored up by higher retained earnings. In these exceptional times, BOU also has continued the policy of strengthening capital buffers by restricting dividend distribution.

The aggregate commercial banks', credit institutions', and MDIs' core capital-to-risk-weighted assets ratio stood at 22.6 percent, 14.8 percent, and 36.4 percent as at the end of September 2021, compared to 22.1 percent, 15.6 percent, and 38.2 percent as at the end of June 2021, respectively. All commercial banks were above the regulatory minimum core capital adequacy requirement of 10.0 percent. Relatedly, the commercial banks' aggregate net profit after-tax (NPAT) increased by 14.8 percent to USh.1.0 trillion for the year ended September 2021, largely driven by increase in interest income from Government securities, from NPAT of USh.874.3 billion for the prior year. However, the CIs and MDIs posted aggregate net losses of USh.8.6 billion and USh.11.9 billion for the year ended September 2021, respectively.

Box 3: Enhancing the Regulatory and Supervisory framework for the banking sector

- **The Financial Institutions (Capital Buffers and Leverage Ratio) Regulations 2020 take effect on January 01, 2022:** In the Regulation, higher capital requirements for Domestically Systemic Important Banks (DSIBs) will be introduced in the form of a Systemic Risk Buffer that varies by bank, and all commercial banks and credit institutions will be required to maintain a capital conservation buffer of 2.5 percent/RWA over and above the minimum ongoing capital ratios, as well as a prudential leverage ratio of 6.0 percent. The introduction of the regulatory requirements is necessary to enhance these banking institutions' capacity to absorb losses without breaching the ongoing regulatory capital requirements, bolster their resilience against potential shocks and minimize the likelihood of their impairment or failure. Based on the September 2021 capital positions, all the DSIBs held sufficient capital buffers to meet their respective systemic risk buffer requirements, and all banks, with a few exceptions, maintained adequate capital buffers to comply with the capital conservation buffer and leverage ratio.

- **Basel II framework:** The implementation of the Basel II remains on course, with full phase-in scheduled for January 2022. The framework is expected enhance SFIs' risk analysis, expand the scope of risks covered by capital to include operational risk, improve market discipline, and augment BOU's regulatory and supervisory framework.
- **Bottom-Up Stress Testing:** Towards enhancing Uganda's financial stability framework, BOU shall conduct the inaugural Bottom-Up Stress Test of the banking system, during December 2021 – March 2022. BOU shall furnish the SFIs with common severe but plausible macro-financial scenarios and require the SFIs to subject their financial performance/statements to the stressed scenarios, in order to assess their capacity to absorb losses from a potential worsening macro-financial scenario. The results of stress testing exercise will inform policy action.

2.4. Structural risk

Banking sector concentration remains high but reduced marginally, with the Herfindahl–Hirschman Index (HHI) on total banking sector assets decreasing from 1,005.7 (March 2021) to 991.3 (September 2021). Also, the five DSIBs' share of total assets reduced from 61.9 percent to 60.3 percent over the year ended September 2021, though a significant portion, 69.8 percent, of the aggregate banking sector NPAT was attributed to the five DSIBs.

To mitigate the potential systemic risk posed by the DSIBs, BOU continues to implement higher regulatory capital and supervisory requirements for DSIBs, as enabled by the Financial Institutions (Capital Buffers and Leverage Ratio) Regulations 2020.

2.5. Performance of payment systems, operational risk, and crisis management

The usage of digital financial and payment services continued to grow, driven by both demand and supply factors. The value of mobile money transactions that rose by 43.1 percent to Ush.124.4 trillion for the year to September 2021, compared to 23.2 percent in the prior year. Table 1 provides details.

With the increasing usage of digital financial and payment services, inherent operational risks, including fraud and cyber threats, are expected to increase. Cognizant of this, BOU continues to enhance oversight over digital financial and payment services, in addition to requiring the operators of digital financial and payments services to enhance risk management, to mitigate potential systemic risks to financial stability.

Furthermore, to strengthen regulation and compliance with Anti-Money Laundering/ Combating the Financing of Terrorism (AML/CFT), BOU shall roll-out AML/CFT focused supervision, starting with targeted inspections of three SFIs in December 2021.

Table 1: Digital payment platform transactions

Platform	Indicator	Year to Sept-20	Year to Sept-21	% Change
Debit cards	Active cards (millions)	2.5	2.7	8.2
	Value of payments (USh. billion)	912	1,601	75.6
Credit cards	Active cards	10,091	10,930	8.3
	Value of payments (USh. billion)	60.5	46.0	-24.0
Points of	Volume	2.7		35.3

Platform	Indicator	Year to Sept-20	Year to Sept-21	% Change
sale	(million)		3.4	
	Value (USh. billion)	571.8	835.1	46.0
Internet banking	Active users	810,094	867,819	7.1
	Value of fund transfers (USh. trillion)	32.7	43.1	31.8
Mobile banking	Active users (million)	1.2	1.4	11.4
	Value of fund transfers (USh. trillion)	1.6	2.9	84.4
Mobile Money	Value of fund transfers (USh. trillion)	87.0	124.4	43.1
	Escrow account balances (USh. Billion)	959.0	1,185.5	23.6

During the quarter to September 2021, 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.

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. The 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 risk dashboard (Table 2) summarizes the key drivers of systemic risks to Uganda's banking sector as at end-September 2021. Overall, risks to financial stability remain elevated but are relatively contained by BOU policy measures. The main risks stem from the macroeconomic environment, with the slow and uneven economic recovery affecting credit risk, which is expected to rise in the near-term, with potential adverse implications for SFIs' performance and solvency.

Table 2: Direction of systemic risk in the quarter ended September 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 is for systemic risks in the Ugandan financial system to remain elevated in the near-term, until stronger and sustained economic growth is realized, and the pandemic is contained.

BOU continues to closely monitor trends in systemic risks and the performance of SFIs as the pandemic evolves, and stands ready to implement further appropriate policy measures to safeguard financial system stability.

5. APPENDIX

5.1 Selected financial soundness indicators for Commercial Banks

	Sep-20	Dec-20	Mar-21	Jun-21	Sept-21
Capital Adequacy (%)					
Total capital/RWA (percent)	22.51	22.15	23.79	23.53	24.09
Core capital/ RWA (percent)	20.89	20.55	22.22	22.06	22.59
NPLs less specific provisions–to–capital	8.86	9.22	8.32	7.39	8.46
Leverage ratio	11.28	10.95	11.95	11.53	11.64
Asset quality (%)					
NPLs to total gross loans	5.15	5.27	5.38	4.79	5.43
NPLs to total deposits	3.11	3.21	3.29	2.86	3.30
Specific provisions to NPLs	43.46	44.99	47.26	47.31	46.48
Earning assets to total assets	69.83	69.14	69.09	69.70	71.53
Return on assets	2.58	2.38	2.53	2.65	2.62
Return on equity	15.12	14.25	14.72	15.48	14.94
Net interest margin	10.45	10.24	10.42	10.17	10.14
Yield on advances	15.24	14.54	14.58	14.18	14.42
Cost of deposits	2.47	2.43	2.43	2.35	2.36
Cost–to–income	74.26	75.08	73.52	71.74	72.59
Liquidity (%)					
Liquid assets–to–total deposits	48.77	50.65	47.58	51.55	49.20
Liquid assets–to–total assets	34.34	35.41	33.30	35.88	34.13
Interbank borrowings to total deposits	2.46	2.14	2.92	2.59	1.93
Market Sensitivity (%)					
Forex exposure to regulatory tier 1 capital	-7.48	-5.99	5.51	-6.57	-7.61
Forex loans–to–forex deposits	62.15	62.15	62.32	59.24	59.79
Forex assets–to–forex liabilities	95.65	99.43	94.28	93.55	86.36

Source: *BOU*

5.2 Selected financial soundness indicators for Credit Institutions

	Sep-20	Dec-20	Mar-21	Jun-21	Sept-21
Capital Adequacy					
Core capital/RWA (percent)	20.8	16.1	16.9	15.6	14.8
Total capital/RWA (percent)	22.0	17.3	18.1	16.8	16.0
Provisions (specific) –to–core capital (percent)	9.5	18.9	17.2	18.9	23.9
Asset Quality					
Total provisions (USh. billion)	19.8	28.4	28.6	30.8	36.3
Non-performing loans (USh. billion)	30.8	49.1	39.0	54.1	61.0
Non-performing loans-to-total loans (percent)	5.3	8.1	6.2	8.1	8.7
Profitability					
Profit/loss (USh. billion)	-6.7	-8.7	-11.4	-13.3	
Return on Assets (ROA)	-0.7	-0.8	0.5	-1.3	-0.7
Return on Equity (ROE)	-3.9	-5.4	2.9	-7.7	-4.8
Liquidity					
Total public deposits (USh. billion)	553.6	593.7	671.7	687.0	690.0
Liquid assets–to–deposits (percent)	57.0	59.2	62.4	53.7	47.5
Loans–to–deposits (percent)	101.9	96.8	88.8	92.4	95.8

Source: *BOU*

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

Indicator	Sep-20	Dec-20	Mar-21	Jun-21	Sept-21
Capital Adequacy					
Core capital/RWA (percent)	35.9	35.4	38.5	38.2	36.4
Total capital/ RWA (percent)	38.6	38.1	41.3	41.0	39.2
Specific provisions–to–core capital (percent)	8.9	9.0	11.3	17.6	28.4
Asset Quality					
Total provisions (USh. billion)	20.7	20.8	25.9	36.9	55.4
Non-performing loans (USh. billion)	36.4	25.7	38.5	47.2	70.5
Non-performing loans–to–total loans (percent)	9.0	6.3	9.8	12.0	17.4
Provisions–to–Non-performing loans (percent)	56.8	80.9	67.4	78.1	78.6
Profitability					
Profit/loss (USh. billion)	13.8	19.8	-1.3	-8.4	-22.0
Return on Assets (YTD, Annualized) (percent)	2.6	2.7	-0.7	-2.3	-4.0
Return on Equity (YTD, Annualized) (percent)	9.3	10.0	-2.3	-7.9	-13.6
Liquidity					
Total deposits (USh. billion)	357.9	355.9	343.6	349.2	396.6
Liquid assets–to–deposits (percent)	32.7	32.9	76.1	73.9	72.8
Liquid assets–to–total assets (percent)	67.1	68.8	35.7	36.2	39.0
Loans–to–deposits (percent)	76.8	74.9	76.1	72.7	71.3

Source: *BOU*