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Quarterly Financial Stability Review

December 2020

Overall, the financial sector remains resilient to the economic disruption associated with the COVID-19 pandemic, and most supervised financial institutions (SFIs) have maintained adequate capital and liquidity buffers to absorb the shock. This has to a large extent been made possible by the Bank of Uganda (BOU) monetary policy and macro-prudential policy measures. Nevertheless, the pandemic and its drawn out nature, in combination with the measures put in place to contain the spread of the virus, have continued to present a challenging operating environment for the banking system and systemic risks to financial sector stability remain elevated, especially from credit risk and operational risk.

1. The Macro-Financial Environment

The most recent update from the International Monetary Fund (IMF) shows that global economic growth contracted by 3.5 percent in 2020, compared to growth of 2.8 percent in the previous year. This decline in growth was mainly driven by diminished global consumption and weak business confidence induced by the pandemic. However, global growth is projected to rise to 5.5 percent in 2021, with the recovery across countries expected to vary depending on: the evolution of the pandemic; efficacy of government policy initiatives and actions; and the timely roll out of vaccine relief.[1]

On the domestic front, **data from the Uganda Bureau of Statistics (UBOS) shows that domestic economic recovery is proceeding at an uneven and slow pace,** with the partial lockdown measures in some sectors including tourism, education and real estate continuing to weigh negatively on the pace of recovery. As a result, firms and households operating in these sectors, and those whose viability depends on related networks, face a more prolonged and challenging recovery outlook. Quarterly economic growth contracted by 6.3 percent and 2.2 percent in June 2020 and September 2020 respectively. The slow pace of economic recovery and the resulting loss of income and reduced cash flows for firms and households, translates into many borrowers continuing to experience difficulty in repaying their loans. Such a development has an adverse knock-on effect on the financial performance of SFIs; and is not expected to change unless and until the spread of COVID-19 is contained, and economic growth is stronger. BOU projections are that real GDP growth will be in the range of 3.0–3.5 percent in the financial year 2020-21.

The residential and commercial property markets have faced vulnerabilities during this downturn. Indicators from UBOS show that residential property prices in Greater Kampala Metropolitan Area (GKMA) contracted by 3.3 percent in the quarter to December 2020. Declining house prices can accentuate the financial stress of households and firms, lower collateral values for loans and negatively impact earnings of SFIs. To date, the impact of falling property prices continues to be effectively muted by the prudent loan-to-value (LTV) ratios maintained by commercial banks. It should be noted that LTV ratios reported by SFIs as at December 2020 were largely within the limit of 85 percent that was set by BOU in May 2020. Borrowers and banks are now generally better able to absorb a greater decline in property

[1] *IMF World Economic Outlook update, January 2021*

prices, and this ameliorates the likelihood of a negative equity situation for a borrower.

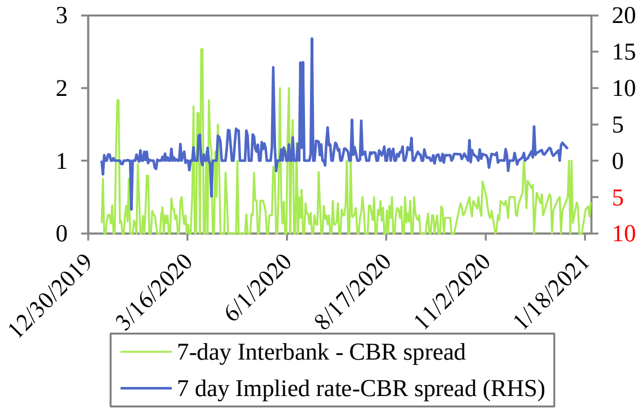
2. Performance of Banking Institutions[2]

2.1. Funding and liquidity

Liquidity risk reduced in the quarter ending December 2020, as most SFIs including all domestic systemically important banks (DSBIs) accumulated ample liquidity buffers, resulting in an improvement in resilience to liquidity shocks. This positive outcome is an indication of the effectiveness of BOU's monetary and macro-prudential policy actions; as well as a significant buildup of deposits driven by fiscal expansion, and increased investment in government securities amidst heightened risk aversion to lending.

The improvement in liquidity conditions was reflected in several indicators. First, **the cost and volatility of domestic interbank funding,** a key indicator of systemic liquidity stress, reduced further over the quarter to December 2020. The 7-day interbank rate reduced to 7.3 percent in December 2020, from 9.1 percent in December 2019. In addition, the spreads between the central bank rate and both the 7-day interbank rate and 7-day implied rate on foreign currency swaps reduced compared to the quarters ended March and June 2020 (Figure 1).

Figure 1: Spreads between interbank market rates and the central bank rate (percent)



***Source:** BOU*

Second, **inflows from offshore investors recovered,** increasing their total assets in Uganda to USh.2.3 trillion, the highest level since November 2016, attracted by the relative stability and returns in the domestic financial markets.

Third, aggregate banking industry **liquid assets grew**. As a result the aggregate ratio of liquid assets to total deposits was well above the regulatory minimum of 20 percent for commercial banks and credit institutions, and 15 percent for microfinance deposit-taking institutions (MDIs) as shown in Table 1.

Table 1: Liquid assets-to-deposits ratio (percent)

As at end of	**Sept-2020**	**Dec-2020**
Commercial banks	48.8	50.7
Credit institutions	57.0	57.0
MDIs	67.1	68.8

***Source:** BOU*

Fourth, **the Liquidity Coverage Ratio (LCR),** an indicator of banks' ability to withstand a 30-day liquidity stress period, remained well above the 100 percent benchmark in the period under review, indicating that on aggregate, banks have built up significant stocks of high quality liquid assets (HQLA) to meet their short-term liquidity needs.

In spite of the slow pace of economic recovery, banks registered **strong growth in customer deposits** of 17.1 percent from USh.22.9 trillion to USh.26.8 trillion over the year ended December 2020. Most of this increase in deposits, amounting to 13.6 percent, occurred between March 2020 and December 2020.

Going forward, potential downside risks to banks' liquidity conditions include: higher non-performing loans if some borrowers under credit relief are still distressed, and a potential reduction in government expenditure with associated accumulation of domestic arrears due to lower revenue.

2.2. Lending activity and credit risk

Credit growth started picking up in the quarter to December 2020, signalling potential recovery. Annually, commercial banks' gross loans rose by 12.5 percent to USh.16.3 trillion, which was higher than

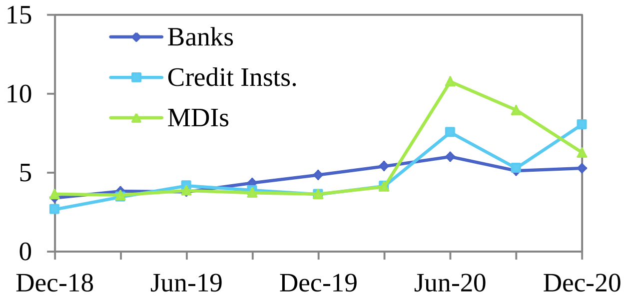
[2] *Banking institutions include commercial banks, credit institutions and microfinance deposit-taking institutions (MDIs), all of which are regulated by BOU.*

the 11.5 percent growth registered in the year ended December 2019. On a quarterly basis, banks' gross loans increased by 3.7 percent over the quarter ended December 2020, up from 1.2 percent to end-September 2020. Net loan extensions (loans granted net of repayments, and excluding capitalized interest) picked up to USh.315 billion for the quarter ended December 2020, from USh.186 billion in the quarter ended September 2020, on account of gradual economic recovery and lower cost of borrowing, although these net extensions remain below pre-COVID-19 levels.

By sector, quarterly growth in credit to the personal and household loans was 7.8 percent; agriculture was 5.1 percent; and manufacturing, 10.7 percent. In contrast, lending to the trade sector contracted by 1.6 percent, and lending to service sectors, including education and hospitality, remains subdued due to the COVID-19 lockdown measures.

However, credit risk from potential deterioration in loan quality remains the primary concern for financial stability. Write offs of bad loans rose by 46.9 percent to USh.242.6 billion in the year to December 2020, indicating prudent risk management by SFIs. The ratio of non-performing loans to total loans (NPL ratio) for commercial banks, credit institutions and MDIs rose from 4.9 percent, 3.6 percent and 3.6 percent in December 2019 to 5.3 percent, 8.1 percent and 6.3 percent in December 2020, respectively, as shown in Figure 2. The rise in NPLs has been moderated by the BOU credit relief measures which have enabled distressed firms and households to restructure their loans and ensured that the economic stresses faced by borrowers are yet to significantly affect banks' asset quality.

Figure 2: Aggregate NPL ratios (percent)



Source: *BOU*

Looking ahead, loan growth is likely to remain subdued until economic recovery picks up and risk aversion by banking institutions eases. Similarly, the trajectory for non-performing loans remains dependent on the recovery in the level of economic activity and the associated effect on the performance of loans under credit relief.

2.3. Box 1: Update on the COVID-19 credit relief Program as at 31st December 2020

Between April 2020 and December 2020, borrowers applied for a cumulative total credit relief of USh.7.9 trillion, of which USh.7.7 trillion was granted by banking institutions, translating to an acceptance rate of 97.6 percent. This implies that 44.6 percent of the gross loans in the banking sector have benefitted from credit relief program since April 2020.

As at end-December 2020, the stock of loans that were still under restructuring was USh.4.8 trillion, equivalent to 29.0 percent of gross loans.

Indicators of performance of credit relief show that;

(i) ***The majority of beneficiaries have resumed paying loans normally*** after the expiry of their credit relief, supported by the lifting of the lockdown for most economic sectors.

(ii) ***Loans under second restructuring have increased, although they are a small share of restructured loans.*** Between August 2020 and December 2020, loans restructured for a second time increased from USh.264.1 billion (5.2 percent of restructured loans) to USh.606.2 billion (12.5 percent of total restructured loans).

(iii) ***Restructured loans that are past due by at least one instalment remain high.*** Between July 2020 and December 2020, they increased from USh.134.1 billion to USh.764.5 billion – equivalent to 15.2 percent of the total stock of restructured loans and 4.4 percent of total gross loans as at end-December 2020. Exposure by some SFIs exceeds 10 percent of their restructured loans.

(iv) Macro stress tests conducted by BOU suggest that most SFIs have adequate capital to absorb losses from deterioration of all past due restructured loans. Nevertheless, banks' resilience will be tested in the next six months if past due restructured loans and loans under second restructuring continue rising materially.

2.4. Capital and profitability

On aggregate, the banking sector held strong capital buffers in the year to December 2020, maintaining resilience to potential shocks. The aggregate core capital-to-risk-weighted assets ratios for commercial banks, MDIs and credit institutions were 20.5 percent, 35.4 percent and 16.1 percent, respectively as at December 2020, well above their respective statutory minima of 10 percent, 15 percent and 10 percent.

Overall banking sector profitability declined in the year to December 2020. The annual net-after-tax profit for commercial banks declined from to USh.883.4 billion to USh.844.3 billion, while credit institutions registered a consolidated loss of USh.8.7 billion from a profitable position of USh.1.5 billion reported for the year 2019. On the other hand, MDIs recorded strong earnings during the period under review as their aggregate net-after-tax profit increased from USh.5.1 billion to USh.19.8 billion. The average cost-to-income ratio for all banking institutions rose from 86.1 percent in 2019 to 92.2 percent at the end of 2020, due to a rise in operating costs.

2.5. Operational risk and risks from payment systems

All systemically important payment systems – the Uganda National Interbank Settlement System, Central Securities Depository and the Automated Clearing House – remained resilient and operated without significant disruptions during the quarter ended December 2020.

The necessary COVID-19 standard operating procedures (SOPs) have continued to affect SFIs' operations, resulting in heightened operational risks. This has been manifested in disrupted operations at some branches, requirements for enhanced business continuity planning and increased banks' cost-to-income ratios.

The use of digital channels for financial services continued to grow strongly during the year to December 2020. In this period, the value of internet and mobile banking transactions rose by 30.2 percent and 135.2 percent respectively. At the same time, the value of mobile money transactions grew by 28.2 percent to USh.93.7 trillion, compared to 2.9 percent in 2019. Over the quarter ended December 2020, the mobile money escrow account balances increased by 42.9 percent to USh.1,083.4 billion.

BOU supports the growth of digital financial service delivery and continues to engage SFIs to address the associated cyber risk, potential exposure to fraud and operational risk. For example, in October 2020, a mobile money fraud effected through a mobile money aggregator affected several banks with potential financial losses of USh.4.4 billion. While the final report of the investigation is yet to be availed, the affected banks have initiated enhancements to their processing systems, as a risk mitigation measure.

Table 2: Digital payment platform transactions

Platform	Indicator	Dec-2019	Dec-2020	Change (%)
Debit cards	Active cards (millions)	2.2	2.6	16.3
	Value of payments (USh. billion)	845.54	925.72	9.5
Credit cards	Active cards	9,821	10,281	4.7
	Value of payments (USh. billion)	63.3	52.3	-17.5
Points of sale	Volume (million)	2.2	2.9	31.2
	Value (USh. billion)	490.4	612.4	24.9
Internet banking	Active users	697,486	810,802	16.3
	Value of fund transfers(USh. trillion)	27.3	35.5	30.2
Mobile banking	Active users (million)	1.1	1.3	20.1
	Value of fund	0.8	1.9	135.2

Platform	Indicator	Dec-2019	Dec-2020	Change (%)
	transfers (USh. trillion)			
Mobile Money	Value of fund transfers (USh. trillion)	73.1	93.7	28.2
	Escrow account balances (USh. Billion)	758.4	1,083.4	42.9

Source: *BOU*

The shut-down of the internet by the Government during January 13-18 2021 also had a severe impact on the operational risks of SFIs. The majority of banks were not able to process outward transfers, clear cheques, perform reconciliation of transactions and make transactions via digital platforms which rely on the internet or online trading platforms. In an effort to ensure that there are adequate contingency measures to support continuity of operations in the event of a similar drastic event in future, BOU tasked all SFIs to establish dedicated leased lines and/or satellite internet systems as a backup solution to provide network connectivity for the core banking systems and other critical systems needed for bank operations.

Further to the above, in order to address the emerging operational and cyber risks related to payment systems, BOU has taken the following actions;

- **Fast tracked the gazzetting of Regulations for the National Payment Systems (NPS) Act 2020**, in order to enhance regulation of emerging risks from payment channels.
- **Embarked on stress tests** and **network analysis for payment systems,** to identify and address vulnerabilities arising from the interconnectedness.
- **Enhanced capacity building for staff** on the evaluation of information and communication technology (ICT) risks and conduct of ICT audits.
- Directed SFIs to enhance risk management, business continuity, internal controls, ICT infrastructure and surveillance.

2.6. Structural and concentration risk

Banking sector concentration, as measured by the Herfindahl-Hirschman Index (HHI), continued on an upward trend during the period under review. As at the end of December 2020, the five largest banks, all DSIBs, (out of 33 banks) accounted for 60 percent of total industry assets, and earned 75 percent of the industry profits, an indication of the dominance of DSIBs. In addition, the sector has witnessed rising exposure to large systemic borrowers with exposures across several banks.

As a way forward, BOU shall soon publish a framework for the regulation and supervision of DSIBs which will include higher capital requirements in excess of other banks, enhanced and more intrusive supervision, and a requirement for all DSIBs to put in place adequate recovery and resolution plans.

3. Summary of Systemic Risks

The dashboard in Figure 3 summarizes the key drivers of systemic risks to Uganda's banking sector as at December 2020. Overall, systemic risks to financial stability remain heightened, largely on account of macro risk, credit risk and structural risk.

Figure 3: Direction of systemic risk in the quarter ended December 2020

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 for Financial Stability and Policy Stance

Near-term risks to financial sector stability have remained relatively contained by BOU policy measures, and the financial sector remains resilient to the economic disruption associated with the COVID-19 pandemic, with adequate aggregate capital and liquidity buffers. Nevertheless, the operating environment for SFIs is likely to remain challenging until the pandemic is contained and economic conditions improve. This outlook implies that BOU policy shall continue to support the capacity of borrowers and banks to absorb the pandemic shock, while remaining watchful as to how the outlook evolves. Accordingly, in order to mitigate the risks highlighted in the foregoing assessment, BOU shall maintain the following policy stance;

a) The C**redit Relief Measures** which were due to expire on 31st March 2021 were extended for six months with effect from 1st April 2021, in order to continue supporting borrowers still affected by the pandemic.

b) The **COVID-19 Liquidity Assistance Program** (CLAP) for SFIs shall stay in place and BOU will review it from to time as the pandemic evolves. The CLAP is aimed at ensuring the viability of solvent SFIs that may come under liquidity stress during the pandemic and to support credit extension.

c) The payment of **dividends and other discretionary distributions** for the year 2020 by SFIs shall be subject to their conducting satisfactory internal capital adequacy assessments (ICAAP) that demonstrates resilience to a range of potential shocks, and risks in their operational environment.

d) The limit of 85 percent on the **loan-to-value (LTV) ratio** for loans for residential mortgages and land purchase was maintained.

e) **In a bid to enhance the resilience of SFIs to shocks, the Financial Institutions (Capital Buffers and Leverage Ratio) Regulations were gazetted on December 30 2020.** As a result, the ratios of core and total capital to risk-weighted assets (RWA) for financial institutions were increased from 10 percent to 12.5 percent and from 12 percent to 14.5 percent, respectively. In addition, DSIBs will be required to hold additional capital buffers in excess of other banks, in the range of 0-3.5 percent.

BOU shall continue to closely assess the emerging risks to financial stability and stands ready to take additional measures in order to safeguard financial sector stability.

5. APPENDIX

5.1. Selected financial soundness indicators for commercial banks

	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Capital adequacy (%)					
Total capital/RWA (percent)	21.78	21.90	22.70	22.51	22.16
Core capital/ RWA (percent)	20.05	20.33	21.07	20.89	20.53
NPLs less specific provisions–to–capital	8.81	9.76	11.16	8.86	9.27
Leverage ratio	10.71	11.78	11.61	11.28	10.94
Asset quality (%)					
NPLs to total gross loans	4.85	5.41	6.01	5.15	5.28
NPLs to total deposits	3.07	3.32	3.66	3.11	3.21
Specific provisions to NPLs	43.73	37.75	39.07	43.46	44.78
Earning assets to total assets	69.76	68.19	67.43	69.83	69.17
Earnings & profitability (%) (YoY)					
Return on assets	2.90	2.76	2.58	2.58	2.38
Return on equity	16.74	15.89	15.24	15.12	14.22
Net interest margin	11.29	11.16	10.89	10.45	10.24
Yield on advances	15.75	16.05	15.53	15.24	14.55
Cost of deposits	2.49	2.56	2.46	2.47	2.43
Cost–to–income	71.99	73.21	74.26	74.26	75.08
Liquidity (%)					
Liquid assets–to–total deposits	48.58	48.81	49.14	48.77	50.65
Liquid assets–to–total assets	33.85	34.26	34.94	34.34	35.45
Interbank borrowings to total deposits	2.10	2.70	1.87	2.46	2.14
Market sensitivity (%)					
Forex exposure to regulatory tier 1 capital	-4.69	-6.52	-6.92	-7.48	-5.99
Forex loans–to–forex deposits	60.06	56.60	62.67	62.15	62.04
Forex assets–to–forex liabilities	92.35	93.79	98.15	95.65	99.43

Source: *BOU*

5.2. Selected financial soundness indicators for credit institutions

	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Capital adequacy					
Core capital/RWA (percent)	20.7	22.2	22.8	20.8	16.1
Total capital/RWA (percent)	22.0	23.5	24.0	22.0	17.3
Provisions (specific) –to–core capital (percent)	9.5	6.2	8.3	9.5	18.9
Asset quality					
Total provisions (USh. billion)	13.1	14.7	18.5	19.8	28.4
Non-performing loans (USh. billion)	19.2	22.1	42.0	30.8	49.1
Non-performing loans-to-total loans (percent)	3.6	4.2	7.6	5.3	8.1
Profitability (12 months ending September)					
Profit/loss (USh. billion)	0.5	1.5	-0.8	-6.7	-8.7
Return on Assets (ROA)	0.1	0.2	-0.1	-0.7	-0.8
Return on Equity (ROE)	0.3	0.9	-0.5	-3.9	-5.4
Liquidity					
Total public deposits (USh. billion)	436.9	489.6	550.8	553.6	593.7
Liquid assets–to–deposits (percent)	48.4	54.9	57.1	57.0	59.2
Loans–to–deposits (percent)	118.7	106.1	97.0	101.9	96.8

Source: *BOU*

5.3. Selected financial soundness indicators for microfinance deposit-taking institutions (MDIs)

	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Capital adequacy					
Core capital/RWA (percent)	37.5	39.1	36.6	35.9	35.4
Total capital/ RWA (percent)	40.1	41.7	39.4	38.6	38.1
Specific provisions–to–core capital (percent)	5.0	5.4	15.5	8.9	9.0
Asset quality					
Total provisions (USh. billion)	12.7	14.0	30.8	20.7	20.8
Non-performing loans (USh. billion)	13.5	15.3	40.6	36.4	25.7
Non-performing loans–to–total loans (percent)	3.6	4.1	10.8	9.0	6.3
Provisions–to–Non-performing loans (percent)	94.2	91.0	75.9	56.8	80.9
Profitability					
Profit/loss (year to date) (USh. billion)	17.8	5.1	- 4.8	13.8	19.8
Return on Assets (YTD, Annualized) (percent)	2.9	3.1	- 1.4	2.6	2.7
Return on Equity (YTD, Annualized) (percent)	9.5	10.3	- 4.7	9.3	10.0
Liquidity					
Total deposits (USh. billion)	284.5	301.7	325.1	357.9	355.9
Liquid assets–to–deposits (percent)	60.7	31.9	34.1	32.7	32.9
Liquid assets–to–total assets (percent)	27.4	70.7	70.9	67.1	68.8
Loans–to–deposits (percent)	79.3	77.4	79.6	76.8	74.9

Source: *BOU*