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Financial Stability Review

Quarter ended 31st December 2019

During the quarter ended December 2019, risks to the banking industry remained moderate. The performance of the banking industry was supported by conducive domestic financing conditions, with a relatively stable foreign exchange rate and reduced interest rates. While non-performing loans rose, the banking industry's resilience to plausible shocks improved, reinforced by an increase in capital and liquidity buffers. A number of emerging risks could weigh on financial sector performance going forward.

1. The Macro-Financial Environment

Global developments

Global output is estimated to have grown by 2.9 percent in 2019. The International Monetary Fund (IMF) forecast global growth at 3.3 percent for 2020, albeit a 0.1 percentage point's downgrade to its earlier (October 2019 report) projections. [1] Market sentiment has been boosted by signs of recovery in manufacturing and global trade, sustained accommodative monetary policy in advanced economies, positive prospects in the US-China trade negotiations, and diminished fears of a no-deal Brexit.

There are several potential downside risks, including the outbreak of the corona virus, lingering threat of more US-China trade tariffs and regional geopolitical risks, which could weigh down investment sentiment in Uganda's export markets and adversely affect loan performance in Uganda.

Global financial conditions remain broadly conducive for stability. However, there are fears that share prices, which had risen sharply in the period to December 2019, may face a correction driven by market sentiment regarding the economic effects of the corona virus. Moreover, the low interest rate environment in advanced economies has also led to higher portfolio flows to emerging market economies, in search of higher yields, including to Uganda. This raises risks from potential reversal of capital flows in future, which could lead to exchange rate volatility and increased roll-over risk.

Domestic macrofinancial conditions

Uganda's economic growth prospects remain strong, with GDP projected to grow by 6.0 percent in 2019/20. However, slower than expected economic growth in early 2019 affected banks' asset quality, with non-performing loans increasing. Domestic financial conditions were largely supportive of financial stability in 2019. Core inflation remained low at 3.0 percent for December 2019 and January 2020. This enabled Bank of Uganda (BOU) to maintain an accommodative monetary policy stance, with the central bank rate being maintained at 9.0 percent. The shilling lending interest rates reduced from an average of 20.1 percent in December 2018 to 18.8 percent in December 2019, while the shilling deposit rate

[1] IMF: *World Economic Outlook Update, January 2020.*

(weighted average) increased from 2.7 percent to 4.1 percent over same period, narrowing the spread on intermediation rates. Furthermore, the foreign exchange market remained relatively stable, with the shilling appreciating against the U.S. dollar, which boosted the performance of foreign currency loans.

Government domestic borrowing needs continued to rise, with the stock of treasury securities increasing by 9.3 percent to USh.18.0 trillion in the quarter ended December 2019, while private sector credit grew by just 3.5 percent to USh.16.8 trillion.[2] This remains a key concern for crowding out credit growth to the private sector.

2. Banking Industry Performance

Total assets, deposits and shareholders' funds:[3] The banking industry's **total assets** increased by 6.0 percent (USh.1.85 trillion) to USh.32.8 trillion, over the quarter ended December 2019, faster than the 2.3 percent growth in the prior quarter. The growth was largely on account of an increase in cash and clearing account balances (by USh.1.20 trillion to USh.4.15 trillion), investment in government treasury securities (by USh.0.65 trillion to USh.7.21 trillion), and gross loans and advances (by USh.0.63 trillion to USh.14.46 trillion).

Banks' aggregate exposure to foreign exchange rate risk reduced marginally, with the proportion of foreign currency denominated loans and liabilities (excluding capital) remaining fairly matched, and reducing from 36.3 percent and 39.8 percent to 35.4 percent and 37.8 percent, respectively. The proportion of foreign currency denominated assets relative to total assets remained low, at 29.0 percent.

Funding: Aggregate funding conditions improved across the banking sector. Retail deposits – the core and more stable funding source for banks – increased by 6.1 percent to USh.22.87 trillion over the quarter. This was higher compared to growth of 7.8 in the previous quarter. Retail deposits constituted 84.1 percent of total liabilities, similar to the position as at end September 2019. Total shareholders' funds rose by 5.4 percent to USh.5.62 trillion, largely due to the quarter's profits.

Liquidity: The aggregate industry liquidity coverage ratio (LCR)[4] improved from 195.8 percent to 234.3 percent over the quarter ended December 2019, and all banks held sufficient high quality liquid assets to meet any sudden demand for liquidity over a 30-day stress scenario, in all currencies. Furthermore, in respect to the regulatory liquid assets–to–deposits ratio, all banks were above the 20 percent minimum requirement, though the aggregate industry ratio decreased from 50.3 percent to 48.6 percent.

Lending: Banks' loans to the private sector increased by 4.6 percent (USh.0.63 trillion) through the quarter; with loans to trade, personal and households, and agriculture sectors increasing most, by USh.158.8 billion, USh.109.6 billion, and USh.94.5 billion, respectively. Exposure to the building, construction and real estate sector still accounts for the largest share, 20.2 percent, of banks' gross loans and advances, albeit a reduction relative to the previous quarter. Exposure to trade, personal loans, agriculture, and manufacturing constitutes 19.2 percent, 18.4 percent, 13.5 percent, and 12.8 percent, respectively.

Prices of real estate property – the main collateral in banks' lending – remained relatively stable. The Residential Property Price Index shows that property prices within Greater Kampala metropolitan area rose by just 0.7 percent during the quarter ended December 2019.[5]

Asset quality: Asset quality, as measured by the ratio of non-performing loans to gross loans and advances (NPL ratio), deteriorated through 2019. The aggregate stock of non-performing loans increased, depressing the NPL ratio to 4.7 percent in

[2] https://www.bou.or.ug/bou/rates_statistics/statistics.html

[3] *Year-on-year, total assets, customer deposits, and total shareholders' funds rose by 16.7 percent, 16.7 percent, and 13.8 percent, respectively, over the year ended December 2019.*

[4] *LCR is a Basel III measure that requires banks to hold sufficient high quality liquid assets, of at least 100.0 percent of net outflows, over a 30-day stress period.*

[5] *Uganda Bureau of Statistics: Residential Property Price Index report, December 2019*

December 2019, worse than 4.4 percent as at end-September 2019 and 3.4 percent as at end-2018, in spite of the registered increase in gross loans and advances. However, the proportion of foreign currency denominated NPLs to total NPLs reduced from 30.1 percent to 28.9 percent through the quarter. 'The category of 'watch loans' reduced quarter ending December 2019, which suggests that NPLs could ease in the first half of 2020.

Earnings and profitability: Year to date bank profitability improved in the year to December 2019. Aggregate net-after-tax profit increased to USh.887.5 billion up from USh.817.0 billion in the period to September 2019. Consequently, the industry's aggregate return on assets (ROA) and return on equity (ROE) were 2.9 percent and 16.8 percent at end December 2019, compared to 2.8 percent and 16.1 percent at end September 2019, respectively.

Capital adequacy: The banking sector remained adequately capitalized. The aggregate industry core and total capital adequacy ratios stood at 20.1 percent and 21.8 percent, respectively at end December 2019. The aggregate banking industry's core capital (CC) and total capital (TC) improved by 3.8 percent and 3.6 percent, respectively, over the quarter under review. All banks, but one, were well above the minimum capital adequacy requirements of 10 percent and 12 percent, for CC/RWA and TC/RWA, respectively.

Resilience of the banking system: Quarterly stress tests conducted on the banking system at the end of December 2019 showed that on aggregate, banks are resilient to most plausible shocks. However, a few banks were less resilient to credit risk shocks due to having highly concentrated loan portfolios; and liquidity risk shocks, entailing a simulated bank run scenario of a sudden withdrawal of short-term deposits, due holding lower liquid assets.

Composite indicators of aggregate risk: Bank of Uganda (BOU) computes two aggregate indicators of systemic risk, which provide an overall assessment of the risk prospects. The first, a systemic *risk dashboard* – which summarizes the main risks and vulnerabilities to Uganda's banking system – indicates that overall risk to the banking system remained low in December 2019 and that macro risks and credit risk are the main risks to systemic stability. The second indicator, *banking sector resilience index,* which consolidates a range of financial soundness indicators, shows that the banking sector's resilience to potential shocks improved in December 2019, albeit marginally, due to an increase in capital buffers and stronger liquidity.

Domestic Systemically Important Banks (DSBs): Once a year in January, BOU conducts analysis to identify DSIBs. For 2020, Stanbic, Standard Chartered, ABSA, and Centenary bank were assessed as domestic systemically important banks (DSIBs). They are thus subject to more stringent regulatory and supervisory requirements.

3. Outlook for Financial Stability

The outlook is for overall macro-financial risks to financial stability in Uganda to remain moderate in the near term, supported by favorable domestic and global economic growth performance and accommodative monetary policy. Downside risks to this outlook include the corona virus outbreak, US-China trade tensions and regional geopolitical risks. The recent uptick in the banking sector's NPLs could be exacerbated by these risks, further affecting provisions and consequently profitability.

4. Regulation and policy actions

The nature of risks highlighted in this review requires micro-prudential policy action, which BOU is already undertaking. Also, BOU will continue to monitor potential systemic vulnerabilities and implement appropriate macro-prudential measures to address threats to stability.

Secondly, BOU has embarked on a survey to verify the Loan-to-Value ratio data for all banks. This will inform policy action to address credit risk in real estate lending, where anecdotal evidence has shown that appraised collateral value for loans is in some cases far higher than the intrinsic value.