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Financial Stability Review

June 2020

The COVID-19 pandemic has continued to adversely affect the financial sector. The shock has led to a slowdown in economic activity and negatively affected the financial conditions of households and businesses, with adverse knock-on effects on the performance of financial institutions. Our outlook points to challenging conditions for the banking sector going forward, mainly driven by the impact of the pandemic shock on economic activity and credit risk. Nonetheless, the decisive measures taken by Bank of Uganda to safeguard financial stability and alleviate the impact of the COVID-19 pandemic on economic growth have been effective and thus, the financial stability policy measures shall remain in place.

1. The Macro-Financial Environment

Economic activity has remained subdued mainly due to the adverse impact of COVID-19. The unprecedented public health crisis and the measures put in place to contain it have weighed down global and domestic economic activity and elevated systemic risks to financial stability. The International Monetary Fund (IMF) projects global growth to contract to -4.9 percent in 2020, worse than their April 2020 forecast of -3.0 percent[1]. On the domestic front, GDP growth declined to -3.2 percent in the quarter ended June 2020. However, high frequency indicators of economic activity point to a recovery in economic activity during July and August 2020, and Bank of Uganda (BOU) projects GDP growth to rise to the range of 3.0 percent to 4.0 percent in the financial year 2020/21.

While the slowdown in GDP growth has adversely affected the financial condition of households and businesses, it is expected that the recovery in economic activity and accommodative monetary policy stance from BOU with the reduction of the central bank rate (CBR) to 7 percent in June 2020 from 9 percent in March 2020, will lead to an improvement in financial stability conditions.

2. Performance of Banking Institutions

2.1. Funding and liquidity

Systemic wholesale funding and liquidity conditions eased in the quarter to June 2020, in line with BOU monetary and macroprudential policy measures.

The risks from wholesale funding costs eased, with the weighted average overnight and 7-day interbank rates averaging 6.5 percent and 7.5 percent, down from 9.3 percent and 10.3 percent in March 2020, respectively. The spread between the 7-day interbank rate and the CBR, a key indicator of market volatility, reduced relative to the previous quarter. Indicators also show that volatility in the flow of foreign investor funds, whereby outflows which had increased in March 2020, stabilized in the quarter to June 2020.

[1] *World Economic Outlook Update*, June 2020, International Monetary Fund

Figure 1: Spread between the 7-day IBR and CBR (percent)

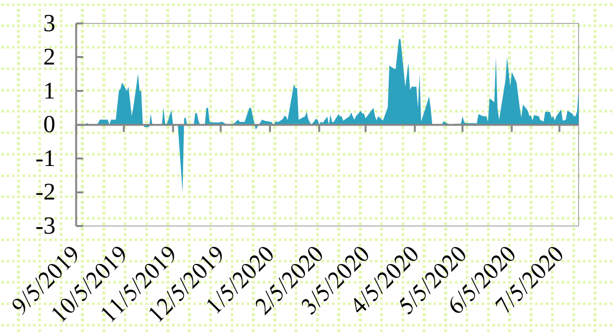

Table 1: Liquid assets-to-deposits ratio for banking institutions (percent)

	June 2018	June 2019	June 2020
Commercial banks	46.6	45.5	49.1
Credit institutions	47.7	52.9	57.1
MDIs	68.9	63.4	70.9

Overall, systemic liquidity risk in the banking sector diminished, as liquidity buffers in all institutions including all systemically important banks (DSIBs) improved, enhancing their resilience to tightening of funding conditions.

The ratio of liquid assets-to-total deposits increased for all supervised financial institutions (SFIs) (Table 1) and was well above the regulatory minimum of 20 percent for banks and credit institutions, and 15 percent for microfinance deposit-taking institutions (MDIs). Similarly, the commercial banks' aggregate liquidity coverage ratio (LCR) shows that save for one bank, all banks were able to meet the 100 percent minimum requirement on a consolidated basis (all currencies) at the end of June 2020[2], thereby holding sufficient high quality liquid assets (HQLAs) to meet their net cash out flows over 30 days. The rise in liquidity buffers was accounted for by increased investment in government securities and cash balances, amidst reduced credit growth.

Nevertheless, there are bank-specific funding shortages among a few institutions. In June 2020, one commercial bank accessed USh.20 billion from the COVID-19 Exceptional Liquidity Assistance Facility that was established by BOU to support banking institutions during the pandemic. In July 2020, one credit institution applied for USh.2.0 billion but withdrew its application, and another commercial bank borrowed USh.40 billion from the Lombard Window.

In order to further address normal bank-specific funding stress, BOU set up a *Standing Lending Facility* in July 2020, which is in the process of operationalisation.

2.2. Lending activity and credit risk

Credit growth remains hampered by the slowdown in economic activity and cautious lending by banking institutions due to the rising credit default rates. Credit risk from deterioration in loan quality remains the key risk to financial stability.

Loans extended by commercial banks increased by 14.0 percent to USh.15.5 trillion over the year to June 2020. However, growth in the six months to June 2020 was subdued, with lending partly comprised of recapitalised interest from loans restructured under credit relief measures amounting to USh.373.5 billion, as well as lending to government for budget support.

Furthermore, risks to credit performance arising from the real estate sector increased as residential property prices declined by 2.9 percent during the quarter ended June 2020[3]. However, the impact of falling property prices on banking institutions' collateral values was alleviated by prudent loan-to-value (LTV) ratios maintained by SFIs, which remained below the

[2] The liquidity coverage ratio (LCR) is a Basel III measure that requires banks to hold sufficient high-quality liquid assets, to cover at least 100 percent of net outflows, over a 30-day stress period.

[3] Residential property price index, Uganda Bureau of Statistics

limit of 85 percent on residential mortgages and land purchase loans that was set by BOU in May 2020. It should be noted, though, that the aggregate LTV ratio on foreign currency loans for land purchase remains above 90 percent.

Asset quality, as measured by the ratio of non-performing loans to total loans (NPL ratio), worsened across the banking industry through the year ended June 2020. The NPL ratio for commercial banks rose from 3.8 percent in June 2019 to 5.8 percent in June 2020, largely due to a rise in in non-performing loans (NPLs) of 73.5 percent or USh.378.5 billion over the year, with a 14.0 percent or USh.109.8 billion increase in NPLs over the quarter to June 2020, with deterioration largely coming from the real estate, trade and commerce, and household sectors. Similarly, the NPL ratios for credit institutions and MDIs rose to 7.6 percent and 10.8 percent respectively during the same period.

Table 2: NPL ratios for banking institutions (percent)

	June 2018	June 2019	June 2020
Commercial banks	4.4	3.8	5.8
Credit institutions	4.1	4.2	7.6
MDIs	4.4	3.9	10.8

The rise NPLs could have been higher but was moderated by the credit relief measures instituted by BOU in April 2020, as illustrated in *Section 2.3.* Looking ahead, asset quality is likely to deteriorate further in the near term, if maturing credit relief is still distressed, as well as on account of a slow recovery in economic activity.

2.3. Update on credit relief facilities restructured during the pandemic

In order to safeguard financial stability and alleviate the impact of the COVID-19 pandemic on the financial sector and economic growth, BOU granted exceptional permission to all banking institutions to provide credit relief through the restructuring of loans of both corporate and individual customers, who were or would be affected by the COVID-19 pandemic. The granting of any credit relief under this initiative has to be effected in the 12-month period from 1st April 2020, and it is at the discretion of the granting institution.

Uptake of credit relief as at end-July 2020

Credit relief for borrowers affected by the pandemic has been implemented successfully so far.

- All SFIs have granted some credit relief except for one which has not yet received any applications. The total loans granted credit relief in April, May, June and July 2020 amounted to USh.5.9 trillion.
- The stock of loans under credit relief in all banking institutions as at end-July 2020 was USh.4.8 trillion, which is equivalent to 31.2 percent of total loans.
- The acceptance rate for applications for credit relief was very high at 98.3 percent, with 893,018 applications approved out of 895,241 received.
- As was expected, the credit relief is benefiting sectors that were forecast to be hardest hit by the pandemic, that is, trade, real estate, manufacturing, and transport sectors.
- The initial credit relief granted in the form of a loan repayment holiday in April-May 2020 is starting to mature, estimated at USh.1.3 trillion. NPLs at SFIs may rise if these borrowers are still distressed.

Some institutions have faced challenges in effectively providing credit relief to borrowers, including limited access to customers due to the pandemic containment measures and misconceptions by borrowers about the eligibility and terms of restructured loans.

In a bid to support the banking institutions' efforts, BOU issued a document with frequently-asked-questions in May 2020 to enhance the public's awareness of the credit relief program and continues to engage institutions to adhere to the consumer protection guidelines and to address emerging issues.

2.4. Capital and profitability

On aggregate, all banking institutions remained adequately capitalized in the year to June 2020. The industry core capital adequacy ratio for commercial banks and credit institutions improved to 21.2 percent and 22.8 percent respectively, at the end of June 2020, well above the regulatory minimum of 10 percent. MDIs' aggregate core capital adequacy ratio stood at 36.6 percent, well above the statutory minimum requirements of 15 percent. The increase in capital was mainly reflective of a slowdown in loan growth and higher retained annual earnings.

On an annual basis, aggregate banking sector profitability increased. However, profitability declined in the six months to June 2020. Aggregate annualised return on assets (ROA) reduced to 2.6 percent, 0.6 percent and -1.4 percent for commercial banks, credit institutions and MDIs respectively, in June 2020. This was mainly due to lower interest income and rising loan loss provisions. During the same period, USh.122.8 billion was expensed by banks on bad loan provisions, compared to quarterly average of Ush.58.6 billion in previous four quarters. Going forward, rising provisions are likely to erode profitability further in near term.

Table 3: Average return on assets for banking institutions (percent)

	June 2018	June 2019	June 2020
Commercial banks	2.8	2.7	2.6
Credit institutions	2.2	2.0	0.6
MDIs	3.1	3.5	-1.4

A related concern is the increased concentration of the banking sector, as the market share of the five largest banks rose to 78.4 percent of the industry profits. This has potential implications for the competitiveness and efficiency of the sector going forward.

2.5. Operational risk

The pandemic has heightened systemic operational risks in the banking system. First, the nation-wide pandemic containment measures have led to the emergence of unprecedented business continuity requirements for financial institutions. A key concern is the potential for the lockdown of head offices and branch locations if a COVID-19 infection occurs, thereby impacting access to financial services and the operation of payment systems. During the quarter ending June 2020, over half of the financial institutions' branches were closed and/or had shorter operating hours. Secondly, the pandemic has also led to greater reliance on cashless/digital payment channels such as online banking, which has enhanced the potential for cyber-related threats.

In order to address the aforementioned operational risks, BOU directed all SFIs in April 2020 and July 2020 to enhance their risk management guidelines, put in place robust contingency plans, effectively implement standard operating procedures (SOPs), and suspend all physical Board meetings.

Nevertheless, the costs associated with managing the operational risk during this pandemic, will likely negatively affect the profitability of SFIs and could drive up access costs to consumers of financial services over the short- to medium-term.

3. Analysis of Risks from Payment Systems

3.1. Systemically important payment systems

All systemically important payment systems remained resilient and operated without significant disruptions during the quarter to June 2020.

3.2. Mobile money payments

The year to June 2020 registered significant growth in mobile money transactions. The value of transactions grew by 19.3 percent to USh.79.8 trillion, of which USh.40.7 trillion was in the second half to June 2020. In addition, the escrow account balances increased by 51.8 percent from USh.632.7 billion in June 2019 to USh. 960.2 billion in June 2020, with an 18.0 percent increase in the quarter ending June 2020.

Table 4: Changes in mobile money transactions

	Jun-17	Jun-18	Jun-19	Jun-20
Mobile money transactions				
Number (billions)	1.1	1.3	2.5	3.1
Annual change (%)	37.3	21.1	85.3	25.4
Value (USh. trillions)	52.8	73.1	66.9	79.8
Annual change (%)	41.0	38.5	-8.5	19.3
Escrow account balances				
Value (billion)	323.2	496.0	632.7	960.2
Annual change (%)	3.1	53.5	27.6	51.8

The surge in mobile money transactions partly reflects measures by BOU and other stakeholders that allowed for free mobile money transactions, free wallet-to-bank and bank-to-wallet transactions with mobile network operators, and no limits on frequency of transactions between March 2020 and June 2020.

3.3. Digital payments

The use of electronic banking and digital payment products also picked up further in the year to June 2020. This trend was partly driven by actions taken by financial institutions to promote the usage of cashless transactions as a measure to reduce the risk of COVID-19 transmission. Debit card, credit card, and point-of-sale (POS) transactions increased. The value of credit card payments rose by 19.7 percent and the number and value of POS transactions rose by 27.5 percent and 14.5 percent respectively.

Internet and mobile banking activity also increased for the year ended June 2020 relative to the previous year. The value of mobile and internet banking transactions increased by 157.3 percent and 52.9 percent, respectively. Active users on internet and mobile banking platforms grew notably by 36.7 percent and 46.9 percent respectively during the same period.

Table 5: Changes in digital payment platform transactions

Platform	Indicator	Jun-19	Jun-20	Change (%)
Debit cards	Active cards (millions)	2.4	2.4	-0.6
	Value of payments (USh. billion)	670.3	3,188.2	375.7
Credit cards	Active cards	9,247.0	10,004.0	8.2
	Value of payments (USh. billion)	56.4	67.5	19.7
Points of sale	Volume (million)	2.0	2.5	27.5
	Value (USh. billion)	485.4	555.8	14.5
Internet banking	Active users	559,391.0	764,533.0	36.7
	Value of fund transfers(USh. trillion)	21.4	32.7	61.1
Mobile banking	Active users (million)	0.7	1.1	46.9
	Value of fund transfers (USh. trillion)	1.1	2.8	163.6

In order to address the risks from these innovations, BOU directed all SFIs to enhance their defences against cyber risk and operational risk.

BOU continues to encourage SFIs to innovate, promote and leverage electronic banking and payment channels, which are also vital for financial deepening. In addition, the National Payment Systems Act 2020 was assented to by the President in July 2020, and BOU is drafting the implementing regulations, which will enhance risk-based regulation of payment systems.

4. Resilience of the Banking System

The resilience index – which consolidates a range of macroprudential indicators, showed that overall, commercial banks' resilience declined significantly in the year to June 2020 due to the COVID-19 pandemic.

Nonetheless, stress tests conducted on the banking sector showed that on aggregate, most institutions, including all the DSIBs, had sufficient liquidity and capital buffers to withstand emerging shocks.

Figure 2 provides a summarised overview of key systemic risks to Uganda's banking sector.

Figure 2: Summary of the direction of systemic risk in the quarter to June 2020

Risk category	Risk direction from previous quarter
Overall risk	⬆
Macro risk	⬆
Credit risk	⬆
Liquidity risk	⬆
Market risk	➡
Profitability & solvency	➡
Structural risk	⬆

5. The Outlook for Financial Stability

The outlook points to challenging conditions for the banking sector going forward, mainly driven by the impact of the pandemic shock on economic activity and credit risk. Systemic risks are likely to remain elevated in the near term until economic recovery is stronger. Empirical research has shown that non-performing loans tend to lag economic activity by a period of 3-6 months. Relatedly, stress tests and risk modelling by BOU projects the aggregate industry NPL ratio to rise to a range of 6 – 10 percent in the near term. **It is important that banks help to absorb but not amplify the shock during this period.**

Consistent with this outlook, the measures implemented by BOU to alleviate shocks to financial stability shall remain in place, including;

- Exceptional permission to SFIs to provide credit relief to borrowers affected by the pandemic, for 12 months effective 1st April 2020.
- Exceptional liquidity assistance facility for SFIs that have or may come under liquidity distress.
- A limit of 85 percent on the LTV ratio of loans for residential mortgages and land purchase, effective 1st June 2020, which has mitigated risks to asset quality and valuation associated with falling property prices.
- The deferring of payment of all discretionary distributions including dividends until further notice which has enabled SFIs to build up capital and liquidity reserves and enhanced their ability to weather the pandemic shock. The total deferred dividends amount to USh.436.3 billion (US$118.72 million).

BOU also implemented enhanced monthly and weekly monitoring of credit risk and liquidity risk respectively and stands ready take additional action as the outbreak evolves, in order to address any emerging risks to financial sector stability.

6. APPENDIX

6.1. Selected financial soundness indicators for commercial banks (percent)

	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20
Capital adequacy					
Total capital to risk-weighted assets	21.3	21.4	21.8	21.9	22.9
Core capital to risk-weighted assets	19.6	19.6	20.1	20.3	21.2
Leverage ratio	11.1	11.0	10.7	11.8	11.6
Asset quality					
NPLs to total gross loans	3.8	4.4	4.9	5.4	5.8
Large exposures to total capital	116.7	116.7	110.0	105.2	108.2
Profitability (Annualised)					
Return on assets	2.7	2.8	2.9	2.8	2.6
Return on equity	15.8	16.1	16.7	15.9	15.5
Net interest margin	11.2	11.2	11.3	11.2	11.0
Cost to income	72.9	72.2	72.0	73.2	74.4
Liquidity					
Liquidity coverage ratio (LCR)	211.4	195.8	234.3	312.9	281.0
Liquid assets to total deposits	45.5	50.3	48.6	48.8	49.1
Market sensitivity					
Forex exposure to core capital	-3.6	-2.4	-4.7	-6.5	-5.1
Foreign currency loans to foreign currency deposits	55.3	56.3	53.6	50.1	54.3

6.2. Selected financial soundness indicators for credit institutions

	Jun-16	Jun-17	Jun-18	Jun-19	Jun-20
Capital adequacy					
Core capital to risk-weighted assets (percent)	22.4	24.3	20.9	21.9	22.8
Total capital to risk-weighted assets (percent)	24.2	25.9	22.5	23.5	24.1
Specific provisions to core capital (percent)	6.1	5.7	7.9	7.6	8.3
Asset quality					
Total provisions (USh. billion)	6.7	7.3	10.7	18.5	18.5
Non-performing loans (USh. billion)	12.8	10.3	13.7	25.6	42.0
Non-performing loans to total loans (percent)	5.3	4.0	4.1	4.2	7.6
Profitability					
Profit/loss (Annualised) (USh. billion)	-1.3	-0.1	4.7	7.5	3.5
Quarterly net profits (USh. billion)	-1.4	-0.7	3.2	4.8	-0.8
Quarterly return on assets (percent)	-0.3	-0.1	0.5	0.5	-0.1
Liquidity					
Liquid assets to deposits (percent)	51.8	53.1	47.7	52.9	57.1
Loans to deposits (percent)	69.6	67.7	69.1	126.3	96.9

6.3. Selected financial soundness indicators for microfinance deposit-taking institutions

Indicator	Jun-17	Jun-18	Jun-19	Jun-20
Capital adequacy				
Core capital to risk-weighted assets (percent)	38.9	44.4	41.8	36.6
Total capital to risk-weighted assets (percent)	42.3	48.0	45.0	39.4
Specific provisions to core capital (percent)	0.8	0.4	0.8	5.5
Asset quality				
Total provisions (USh. billion)	13.0	11.4	11.3	30.8
Non-performing loans (USh. billion)	14.0	12.0	12.8	40.6
Non-performing loans to total loans (percent)	5.0	4.4	3.9	10.8
Provisions to non-performing loans (percent)	92.5	94.6	88.3	75.9
Profitability (Annualised)				
Profit/loss (USh. billion)	6,57	7.3	9.1	-4.8
Return on assets (percent)	3.1	3.1	3.5	-1.4
Return on equity (percent)	9.2	9.2	10.1	-4.7
Liquidity				
Liquid assets to deposits (percent)	66.3	68.9	63.4	70.9
Liquid assets to total assets (percent)	28.3	30.9	27.8	34.1
Loans to deposits (percent)	74.1	80.5	77.4	79.6