BANK OF UGANDA

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Financial Stability Review

Quarter ended 31st March 2020

The last quarterly report indicated that systemic risks to financial sector stability remained moderate. It is now clear that the outbreak and spread of the coronavirus (Covid-19) pandemic poses a serious and unprecedented threat to financial stability. Among other effects, it has led to a slowdown in global and domestic economic activity, adversely affected borrowers' financial health and increased systemic liquidity pressures. To safeguard financial stability, BOU took decisive action in March 2020 and April 2020 which led to relative stability, including instituting credit relief for borrowers and established a Liquidity Assistance Program for Supervised Financial Institutions (SFIs) that may come under liquidity stress. In addition, on aggregate, SFIs hold strong liquidity and capital buffers. The near-term outlook for financial stability depends on the duration and severity of the pandemic. BOU stands ready to take additional measures as the pandemic evolves to alleviate emerging shocks to and support financial stability and growth.

1. The Macro-Financial Environment

Global developments

The COVID-19 pandemic has immeasurably affected the global economy. Global GDP growth is forecast to contract sharply to -3 percent in 2020, much worse than during the 2008–09 financial crisis[1]. The pandemic also resulted in the tightening of global financial conditions at an unprecedented speed. Notably, emerging and developing economies experienced the sharpest reversal in portfolio flows on record. At this time, the ultimate economic impact as well as timing of recovery remains highly uncertain.

Domestic conditions

On the domestic front, Uganda's GDP growth forecast was revised down to a range of 3.0 to 4.0% for the FY 2019/2020, much lower than 6.0 to 6.3%.[2] The necessary containment measures for the pandemic have slowed down economic activity across most sectors of the economy including tourism, transport and trade. This has impaired the ability of borrowers to service their debt obligations and is a threat to financial stability.

To support growth, Bank of Uganda (BOU) eased monetary policy, reducing the Central Bank Rate (CBR) by 100 basis points to 8.0 percent in April 2020. This was aided by subdued inflation, with the annual headline and core inflation reducing to 3.0 percent and 2.5 percent for March 2020, from 3.6 percent and 3.0 percent in December 2019, respectively.

As uncertainty and volatility rocked the global financial markets in March 2020, some offshore investors exited shilling positions in Uganda, which led to severe depreciation pressures on the shilling. BOU intervened to smoothen out the volatility and support exchange rate stability. While there is a risk that large capital outflows can exacerbate domestic shocks from the pandemic, indicators show that outflows have slowed down considerably since April 2020.

2. Banking Industry Performance

[1] International Monetary Fund, *World Economic Outlook Report* & *Global Financial Stability Report*, April 2020.
[2] BOU Monetary Policy Statements, April 2020 and August 2019.

Total assets: Commercial banks' total assets increased by 2.3 percent over the quarter ended March 2020 to USh.33.6 trillion, slower than 6.0 percent growth over the prior quarter ended December 2019. Growth was largely on account of an increase in bank placements with non-resident banks which rose by 29.1 percent. Foreign currency denominated assets registered higher growth of 7.3 percent (*or 3.6 percent, net of exchange rate depreciation effect*), compared to shilling denominated assets that rose by 0.3 percent as at end-March 2020. This indicates higher exposure of bank balance sheets to foreign exchange risk.

Lending: Banks' lending to the private sector slowed down over the quarter ended March 2020, with gross loans and advances increasing by 0.2 percent, to USh.14.5 trillion, slower than the 4.6 percent increase over the prior quarter. Shilling denominated loans rose by 1.3 percent, while foreign-currency denominated loans decreased by 1.8 percent. There was a decrease in lending to key tradable sectors: trade by 2.2 percent; manufacturing by 3.5 percent; and agriculture by 2.4 percent. Credit growth is likely to remain subdued until the pandemic is contained globally and domestically and economic growth picks up. This is likely to affect banks' income and profitability. In addition, a prolonged slowdown in economic activity could depress residential property prices and invariably lower collateral valuations, with adverse implications for credit risk.

Asset quality: Measured by the ratio of non-performing loans to gross loans and advances (NPL ratio), asset quality deteriorated, a trend observed since March 2019. The stock of non-performing loans (NPLs) increased by 14.9 percent to USh.782.6 billion, and consequently the industry aggregate NPL ratio worsened from 4.7 percent to 5.4 percent over the quarter ended March 2020. This trend was observed across most banks and sectors, although agriculture was affected most. By currency, the stock of foreign currency and shilling NPLs rose by 34.8 percent and 7.0 percent, respectively. In the near term, risk modelling by BOU forecasts the NPL ratio to rise to a range of 6.3-12.3% over the next six months, especially given the rise in 'watch loans' category during March 2020. However, this effect will be moderated by the credit relief measures issued by BOU in April 2020.

Funding: Customer deposits, which make up 84.7 percent of banks' total liabilities, increased by 3.1 percent over the quarter ended March 2020 to USh.23.6 trillion, slower than 6.1 percent growth registered over the quarter ended December 2019. Foreign currency and shilling denominated deposits rose by 4.2 percent and 2.4 percent, respectively.

The quarter ended March 2020 witnessed increased wholesale funding costs for banks amidst tight market liquidity conditions and market uncertainty. The weighted average overnight and 7-day interbank rates averaged 9.3 percent and 10.3 percent, up from 7.7 percent and 9.1 percent in December 2019, respectively. The rise in interest rate spreads suggests heightened perception of counterparty risk in the interbank shilling market manifested in higher risk premiums. Banks sought more wholesale funding, with net borrowings (from the interbank, BOU discount window, and non-resident banks) rising by 41.9 percent (USh.297.7) billion over the quarter.

Liquidity: Indicators show that on aggregate, banks hold strong liquidity buffers to withstand any tightening in funding conditions. The aggregate industry liquid assets–to–total deposits ratio improved from 48.6 percent to 48.8 percent, with all banks above the regulatory minimum of 20.0 percent. Similarly, the aggregate industry liquidity coverage ratio (LCR) improved to 322.5 percent on a consolidated basis and 187.2 percent in Uganda shillings over the quarter ended March 2020, from 234.3 percent and 179.5 percent, respectively, in the previous quarter.[3]

Earnings and profitability: For the 12 months ended March 2020, the aggregate industry net-after-tax profit was USh.863.6 billion, compared to USh.887.5 billion for the year ended December 2019. Accordingly, the aggregate return on assets (ROA) and return on equity (ROE) ratios reduced from 2.9 percent and 16.8 percent to 2.8 percent and 16.0 percent respectively. The outturn for profitability was largely due to a reduction in interest income coupled with an increase in

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

provisions for loan losses. Moreover, the aggregate cost-to-income ratio increased from 71.9 percent to 73.2 percent, driven by a rise in loan loss provisions and persistently high staff costs.

Capital adequacy**:** The banking sector remained adequately capitalized during March 2020. The aggregate industry core capital-to-risk-weighted assets (RWA) and total capital-to-RWA ratios increased from 20.1 percent and 21.8 percent in December 2019 to 21.0 percent and 22.6 percent as at end-March 2020, respectively. The improvement in capital buffers was largely due to the booking of USh.780.3 billion as retained earnings from 2019 financial performance. The ***leverage ratio,*** the non-risk-weighted measure of capital adequacy, improved from 11.5 percent to 11.8 percent, indicating an improvement in the core capital cushioning of both on- and off-balance sheet exposures

Resilience of the banking system**:** Stress tests conducted on the banking sector showed that on aggregate most banks, including all the DSIBs, have sufficient liquidity and capital buffers that provide resilience to Covid-19 related losses**.** The resilience index – which consolidates a range of financial soundness indicators, showed an improvement on aggregate, albeit with slight decline for some segments in the banking sector. In addition, Quarterly micro stress tests conducted on the banking system at the end of March 2020 showed that on aggregate, the banking sector is resilient to most plausible shocks in the short term.

Domestic Systemically Important Banks (DSIBs)**:** All the four DSIBs – Stanbic, Standard Chartered, ABSA, and Centenary bank– held sufficient capital and liquidity buffers as at end-March 2020 and were profitable for the quarter. BOU continues to subject the DSIBs to more stringent regulatory and supervisory oversight.

3. Policy Interventions

In order to safeguard financial stability and alleviate the impact of the Covid-19 pandemic on the financial sector and economic growth, BOU has taken the following decisive measures since March 2020.

(i) Set up a Liquidity Assistance Programme for Supervised Financial Institutions (SFIs) facing liquidity pressures in order to ensure that they continue to provide financial services including lending to solvent businesses in need of credit.

(ii) Provided exceptional permission to SFIs to provide credit relief and loan restructuring to borrowers that may be at risk of going into distress due to the COVID-19 pandemic, for one year effective April 1st 2020.

(iii) Deferred payment of all discretionary distributions by all Supervised Financial Institutions including dividends and bonuses until further notice. This action will ensure that banks continue to operate effectively by enabling them to build up capital and liquidity reserves during the Covid-19 period.

(iv) Directed all SFIs to put in place incentives to drive and promote the use of digital platforms, so as to minimize the spread of Covid-19 by reducing the need for human interaction and use of cash, while ensuring that financial services remain available.

(v) Directed all SFIs to put in place adequate occupational health and safety measures to minimise risk of infection of customers and staff, relaxed the approval process of opening and closing of branch locations and working hours, and suspended face to face meetings for the Boards and senior management of banks in line with Government Standard Operating Procedures (SOPs).

(vi) Set a limit of 85% on the Loan to Value Ratio (LTV) for new residential mortgage loans and loans for land purchase, with effect from June 1 2020, in order to alleviate the risk of bank losses from reduced property prices.

4. The Outlook for Financial Stability

In the next quarters of 2020, domestic and global macro-financial risks to financial stability are likely to remain heightened, in comparison to 2019. The outlook for financial sector stability depends on the severity and duration of the Covid-19 pandemic, both of which remain uncertain at this time. However, given that changes in credit risk typically lag trends in economic activity by 3-6 months, it is likely that bank's asset quality will deteriorate further in 2020. Overall, Banks including all DSIBs held strong capital and liquidity buffers at the start Covid-19 pandemic, which are the first line of defence to absorb losses and funding pressures. These buffers, supported by the actions taken by

BOU, are adequate to alleviate the effects of the pandemic on financial stability.

Notwithstanding the above, BOU stands ready to introduce additional measures as the outbreak evolves, in order to safeguard the stability and integrity of the financial sector. In addition, BOU will continue to work with other financial sector regulatory agencies through the Financial Sector Stability Forum (FSSF), to ensure a coordinated response to the pandemic in order to reduce the potential for systemic contagion.

5. Appendix

Select Indicators (%)	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Capital Adequacy					
Regulatory capital to risk-weighted assets	22.25	21.32	21.36	21.00	22.60
Regulatory tier 1 capital to risk-weighted assets	20.41	19.57	19.62	20.10	21.80
Leverage ratio	11.46	11.05	11.02	11.50	11.78
Asset quality					
NPLs to total gross loans	3.82	3.79	4.35	4.71	5.41
Large exposures to total capital	110.51	116.72	116.68	110.00	105.19
Earnings & profitability (YoY)					
Return on assets	2.83	2.69	2.81	2.91	2.78
Return on equity	15.90	15.83	16.09	16.81	16.01
Net interest margin	11.04	11.19	11.24	11.29	11.09
Cost to income	72.08	72.87	72.23	71.90	73.20
Liquidity					
Liquidity Coverage Ratio (LCR)	197.87	211.41	195.80	234.30	322.50
Liquid assets to total deposits	44.06	45.47	50.29	48.58	48.81
Market Sensitivity					
Forex exposure to regulatory tier 1 capital	- 4.27	- 3.61	- 2.43	8.10	- 5.08
Foreign currency loans to foreign currency deposits	68.25	61.78	62.76	60.06	56.60

Select Balance Sheet Items (USh 'Trillion')	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Total Assets	28.63	30.28	30.97	32.83	33.59
Gross Loans and Advances	13.05	13.58	13.83	14.46	14.49
Government Securities	6.77	6.62	6.57	7.21	7.37
Customer Deposits	19.56	20.99	21.55	22.87	23.58
Placements with Banks abroad	2.15	2.39	2.33	2.60	3.36

Non-performing loans - by sector (USh 'Billion')	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Agriculture	157.77	156.72	154.80	151.41	185.14
Mining & Quarrying	0.35	0.58	0.24	0.24	0.04
Manufacturing	52.40	52.00	37.16	44.52	42.03
Trade & Commerce	87.14	82.71	129.81	207.77	199.71
Transport & Communication	10.11	20.41	19.27	16.46	14.88
Building, Construction & Real Estate	65.94	81.11	128.40	131.72	133.72
Electricity & Water	0.35	0.87	0.19	0.26	58.33
Business Services	18.27	17.54	16.94	18.75	20.80
Community, Social & Other Services	34.41	32.50	26.04	30.17	11.17
Personal & Household Loans	67.27	65.82	70.10	74.53	109.58
Other Activities	4.26	4.76	18.73	5.53	8.39
Staff Loans	0.17	0.05	-	-	-
Total NPLs	**498.43**	**515.07**	**601.68**	**681.37**	**782.60**