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Quarterly Financial Stability Review

September 2020

Near term risks to financial stability have been relatively contained through decisive policy measures by Bank of Uganda (BOU). Nevertheless, the operating environment for the financial sector remains challenging, with vulnerabilities related to the slow pace of economic recovery and its adverse impact on the financial condition of households and businesses, as well as banking institutions' asset quality and exposure to operational risk. Credit extension by banking institutions remains subdued, which would otherwise propel faster economic recovery. Risks to financial stability are likely to remain heightened going forward, until economic recovery is stronger. However, on aggregate banking institutions have strong liquidity and capital buffers to absorb emerging shocks.

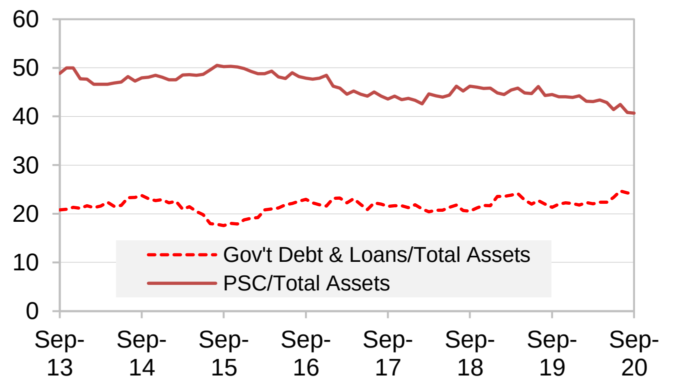
1. The Macro-Financial Environment

The slow pace of global and domestic economic recovery, mainly due to the adverse impact of COVID-19, has continued to adversely affect financial system stability. The latest forecasts from the International Monetary Fund project global output to contract by 4.4 percent in 2020, a 0.5 percentage point improvement compared to the June 2020 forecast[1]. Domestic GDP growth is forecast in the range of 2.0-3.0 percent for the financial 2020/21[2] and indicators show that economic activity has started to pick up in some sectors including trade and real estate.

In this environment, Bank of Uganda's (BOU) accommodative monetary policy stance, with the Central Bank Rate (CBR) maintained at 7.0 percent since June 2020, has continued to support loan repayment and private sector credit (PSC) growth. Nevertheless, it is evident that the financial condition of households and businesses is yet to fully recover, which is likely to continue adversely affecting their servicing of contractual obligations such as loans with knock-on effects on the performance of the financial sector.

During the year to September 2020, holdings of government debt by commercial banks picked up, growing by 24.7 percent and driving the growth in total assets of 19.0 percent. Relative to their total assets, banks' exposure to domestic government debt has been rising, and on aggregate, commercial banks hold about 40 percent of the government domestic debt. The increased investment in government debt by banks partly reflects risk aversion due to concerns about asset quality in the COVID-19 period. However, it also points to rising risk of crowding out private sector lending, as illustrated in Figure 1.

Figure 1: Banks' exposure to the government and private sector credit (percent)



Source: *BOU*

[1] *World Economic Outlook Report*, October 2020, International Monetary Fund

[2] *Monetary Policy Statement*, October 2020, Bank of Uganda

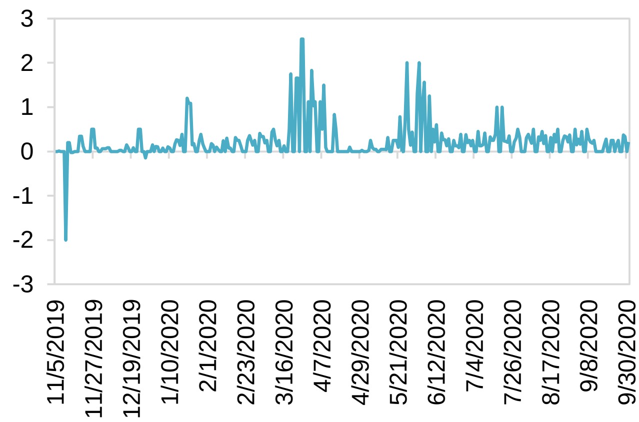
2. Performance of Banking Institutions[3]

2.1. Funding and liquidity

Liquidity conditions in the banking system continued to improve through the quarter ended September 2020, partly supported by decisive BOU monetary and macro-prudential policy measures and strong growth in deposits.

Indicators of wholesale funding conditions improved during the quarter to September 2020. The cost of borrowing in the money markets reduced, with the weighted average interbank 7-day and overnight rates reducing to 7.3 percent and 6.8 percent in September 2020, from 10.2 percent and 8.7 percent in September 2019, respectively. Moreover, interbank volatility reduced, with the spread between the 7-day interbank rates (IBR) and CBR easing further (Figure 2).

Figure 2: Spread between the 7-day IBR and CBR (percent)



Source: *BOU*

In addition, offshore investor inflows into the domestic financial markets continued to grow, enhancing the availability of funding for banks and supporting shilling stability. Offshore investors' total assets in the banking system rose to USh.1.6 trillion in September 2020 from USh.1.4 trillion at the end of May 2020, thereby reversing the trend of outflows that was experienced around March and April 2020 at the height of the uncertainty and risk aversion in global financial markets.

The improvement in liquidity conditions was also witnessed in the buildup in aggregate liquidity buffers, including for all systemically important banks (DSIBs). The aggregate ratio of liquid assets to total deposits was well above the regulatory minimum of 20 percent for banks and credit institutions, and 15 percent for microfinance deposit-taking institutions (MDIs) as shown in Table 1. Relatedly, the commercial banks' aggregate liquidity coverage ratio (LCR) stood at 218.5 percent as at end of the quarter, with all banks but two above the 100 percent regulatory minimum requirement on a consolidated basis (all currencies).[4] The growth in liquid assets was supported by the rising investment in government securities amidst low credit growth and a pickup in deposit growth. Customer deposits have registered strong growth during the COVID-19 period, with annual growth of 20.2 percent to USh.25.96 trillion in the year to September 2020, partly on account of lower aggregate demand and fiscal expansion. The buildup of liquid assets resulted in an improvement in the resilience of the banking sector to systemic liquidity risk.

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

	Sept. 2018	Sept. 2019	Sept. 2020
Commercial banks	43.9	50.3	48.8
Credit institutions	42.9	47.0	57.0
MDIs	67.5	62.4	67.1

Source: *BOU*

Notwithstanding the enhanced aggregate liquidity position, there were idiosyncratic liquidity shortages among a few banks. BOU extended liquidity support to two banks – one accessing USh.20 billion from the COVID-19 Exceptional Liquidity Assistance Facility (CLAP) in June 2020, and the other borrowed USh.40 billion from the Lombard Window in July 2020. Both banks took steps to enhance their liquidity buffers and have since fully paid back the borrowings from BOU. Going forward over the next quarter, systemic liquidity risk in the banking sector is likely to remain moderate, but a few banks may continue to experience institution-specific challenges.

[3] Banking institutions include commercial banks, credit institutions and Microfinance deposit-taking institutions, regulated by BOU.

[4] 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.

Further to the *Standing Lending Facility* which BOU operationalised in July 2020 to address normal day-to-day liquidity gaps that banking institutions may face, the Bank has embarked on enhancing the Lender of Last Resort function by setting up the *Emergency Liquidity Assistance framework* to support solvent banking institutions, which may come under liquidity distress.

2.2. Lending activity and credit risk

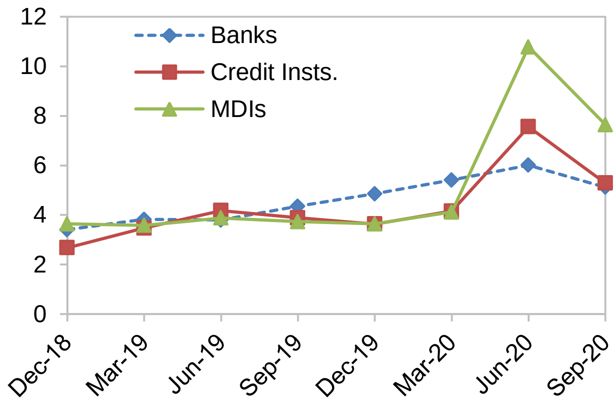
Credit growth remains subdued partly due to slow economic recovery, deterioration in loan quality, as well as supply and demand factors. Asset quality remains the key concern for financial stability.

On an annual basis, total loans and advances increased by 13.5 percent to USh.15.7 trillion for commercial banks and by 15.5 percent to USh.408.9 billion for MDIs, but decreased by 7.3 percent to USh.582.4 billion for credit institutions. On a quarterly basis, loan growth to September 2020 for banks was 1.2 percent, mainly to the personal and household sector, real estate sector and trade sector. However, a large portion of new net lending was comprised of recapitalized interest on loans under credit relief, amounting to USh.293.0 billion.

On a positive note, the residential property price index (RPPI) has started to pick up, with a 5.8 percent increase in prices of property in Greater Kampala Metropolitan Areas (GKMA) during the quarter to September 2020, a recovery from - 2.9 percent that was registered over the quarter ended June 2020[5]. The prudential loan-to-value (LTV) limit of 85 percent on residential mortgages and land purchase loans, set by BOU in May 2020, remains in effect to mitigate any potential adverse implications of real estate sector developments on financial stability.

Asset quality, as measured by the ratio of non-performing loans to total loans (NPL ratio), worsened across the banking industry over the year ended September 2020. The commercial banks' aggregate NPL ratio rose from 4.4 percent in September 2019 to 5.1 percent in September 2020. However, on a quarterly basis, commercial bank's NPL ratio for September 2020 was an improvement compared to 6.01 percent in June 2020. The evolution of asset quality for credit institutions and MDIs largely has followed a trend that is similar to that of commercial banks, as shown in Figure 3. The improvement in the NPL ratio across the banking industry during the quarter to September 2020 partly reflects intensified loan recovery efforts, increased prudent write-offs and higher loan repayments following the lifting of the lockdown.

Figure 3: NPL ratios for banking institutions (percent)



Source: *BOU*

It is important to keep in mind that non-performing loans in banking institutions could have been worse but are being moderated by the BOU COVID-19 credit relief program which has allowed distressed borrowers to restructure their loans, including accessing loan repayment holidays. Looking ahead, asset quality could deteriorate further in the near term if maturing credit relief is still distressed, as well as on account of the slow recovery in economic activity.

Box 1: Update on the COVID-19 credit relief Program as at 30th September 2020

In April 2020, 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 objective was to safeguard financial stability and alleviate the impact of the COVID-19 pandemic on the financial sector and economic growth.

The status as at end September 2020 was as follows;

- All banking institutions, except one which is yet to receive any applications, have extended

[5] *Residential property price index (RPPI) report*, September 2020, Uganda Bureau of Statistics

considerable credit relief to borrowers affected by the pandemic thus far.

- The cumulative loans that have been granted credit relief between April 2020 and end-September 2020 amount to USh.6.7 trillion, which is 40 percent of the banking sector's loan portfolio. The acceptance rate for applications is high at 97.4 percent.
- After accounting for credit relief that has matured/expired as well as new applications restructured during the month, the stock of restructured loans as at end of September 2020 was USh.5.2 trillion, equivalent to 31.5 percent of gross loans.
- Loans that have been restructured for a second time increased by 60.8 percent from USh.264.1 billion in August 2020 to USh.424.9 billion in September 2020, and these account for 8.1 percent of all restructured loans. This trend suggests that the financial condition of some borrowers that received credit relief remains distressed.
- As expected, credit relief is benefiting sectors that were forecast to be hardest hit by the pandemic; trade, real estate, manufacturing, transport.
- The amount of loans under credit relief that are past-due by at least one monthly repayment increased from USh.134.1 billion as at end of July 2020 to USh.763.2 billion at end-September 2020. Moreover, some banking institutions' share of past-due restructured loans to their total loans is quite significant. This portends deterioration in asset quality going forward.

As a remedy for concerns regarding the potential impact of past due restructured loans on banks' performance, BOU took the following actions;

(i) stress tests were conducted in order to determine the adequacy of banking institutions' provisions and capital buffers to absorb the shock if all the past due loans were to deteriorate to npls, and the results indicated that all banking institutions, except for two, were adequately capitalised to absorb the losses.

(ii) BOU continues to engage banking institutions to ensure that they proactively recognise and prudently provision for potential loan losses and maintain adequate capital and liquidity buffers to absorb the shock.

(iii) Furthermore, in October 2020, BOU embarked on a countrywide publicity campaign to enhance awareness of the credit relief program, in order to ensure that borrowers who are still distressed can apply for and access a second restructuring, which is allowed under the BOU credit relief guidelines.

2.3. Capital and profitability

On aggregate, the banking sector remained adequately capitalized to absorb emerging shocks. The aggregate core capital-to-risk-weighted assets (RWA) ratios for commercial banks, credit institutions and MDIs were 20.9 percent, 20.8 percent and 35.9 percent, respectively as at end of September 2020, well above the statutory minimum of 10 percent and 15 percent (MDIs). The increase in capital was largely boosted by an improvement in aggregate profitability.

On an annual basis, aggregate banking sector profitability increased for the 12 months ended September 2020. The net-after-tax profit for commercial banks and MDIs rose by 6.9 percent to USh.874.3 billion, and 1.5 percent to USh.13.8 billion, respectively, while credit institutions' registered an aggregate loss of USh.5.5 billion, for the year ended September 2020. Profitability was boosted by a decrease in provisions for bad debts. However, going forward, potential deterioration in asset quality could lead to an increase in specific provisions and erode the banking sector's profits whilst reducing capital buffers.

Increased concentration and segmentation of the banking sector remains a concern, with potential implications for the competitiveness and efficiency of the sector going forward. As at end of September 2020, the five largest banks accounted for 62.1 percent of total industry assets, and earned 75.2 percent of the industry profits for the year ended.

2.4. Operational risk

The pandemic has heightened systemic operational risks in the banking system, with potential adverse implications for profitability. Notably, most banking institutions continue to be affected by the disruptions and costs associated with temporary branch closures in the event of COVID-19 infections. In addition, as pointed out in the last *quarterly report*, the increased adoption of electronic/digital platforms to deliver financial services electronically has increased exposure to cyber risk. Social distancing requirements have also had the implication of limiting banking institutions' staff deployed on-site, consequently enhancing costs of facilitating working offsite and operational risks.

In July 2020, BOU resumed on-site examinations of banking institutions but changed the model and will now conduct such examinations remotely but with full access to information from banking institutions, except in cases of targeted inspections. The targeted on-site inspections are conducted with full compliance with the COVID-19 standard operating procedures (SOPs) as issued by the Government.

3. Analysis of Risks from Payment Systems

3.1. Systemically important 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 September 2020.

3.2. Digital/electronic payments

The year to September 2020 registered significant growth in digital/electronic transactions, including mobile money. Banks have continued to promote usage of e-money and digital platforms, and more so as a measure to reduce the risk of COVID-19 transmission.

Over the year to September 2020, the value of debit card payments increased by 18.3 percent from USh.777.1 billion in the year ended September 2019 to USh.912.2 billion transacted during the year ended September 2020. Contemporaneously, the value of credit card payments rose by 1.4 percent, from USh.59.7 billion to USh.60.5 billion. Furthermore, the value of transactions at point-of-sale (POS) terminals rose by 20.6 percent, respectively.

Similarly, the value of transactions processed through mobile money and mobile banking increased by 23.2 percent to USh.87.0 trillion and 80.0 percent to USh.1.6 trillion during the year ended September 2020. This growth was mostly registered during the half-year to September 2020, as banking institutions leveraged technology to promote digital channels for delivery of financial services. Table 2 provides details about the developments in digital payments.

Table 2: Digital payment platform transactions

Platform	Indicator	Sept. 2019	Sept. 2020	Change (%)
Debit cards	Active cards (millions)	2.1	2.5	19.3
	Value of payments (USh. billion)	777.1	912.2	18.3
Credit cards	Active cards	9,565.0	0,091.0	5.5
	Value of payments (USh. billion)	59.7	60.5	1.4
Points of sale	Volume (million)	2.0	2.7	31.1
	Value (USh. billion)	474.0	571.8	20.6
Internet banking	Active users	678,777	810,094	19.4
	Value of fund transfers(USh. trillion)	38.4	32.7	-14.9
Mobile banking	Active users (million)	1.0	1.3	20.7
	Value of fund transfers (USh. trillion)	0.9	1.6	80.0
Mobile Money	Value of fund transfers (USh. trillion)	70.6	87.0	23.2
	Escrow account balances (USh. Billion)	682.1	959.0	40.6

Source: *BOU*

The use of digital payments is expected to increase as more banking institutions leverage technology innovations to extend and serve their customer base. However, this growth poses higher potential for cyber risk, fraud and operational risk.

In order to address the operational and cyber risks highlighted above, BOU continues to engage banks to ensure that they implement enhanced risk management, robust contingency plans and effective SOPs. Furthermore, the National Payment Systems Act, 2020 which was gazzetted on 4th September 2020, as well as the enabling regulations whose drafting is underway, will enhance the supervision and regulation of risks to financial stability from the payments industry.

4. Conclusion

The operating conditions for the banking sector are likely to remain challenging until economic growth picks up. The resilience index, which aggregates a range of financial sector and economic indicators, shows that overall, the banking system's resilience to shocks remains strong, despite concerns about the performance of a few institutions. In addition, macro stress tests conducted by BOU showed that most banking institutions, including all the DSIBs, had sufficient liquidity and capital buffers to withstand emerging shocks from a range of adverse scenarios. Figure 4 summarizes the key drivers of systemic risks to Uganda's banking sector as at September 2020.

Figure 4: Direction of systemic risk in the quarter ended September 2020

Risk category	Risk direction from previous quarter
Overall risk	↑
Macro risk	↑
Credit risk	↑
Liquidity risk	→
Market risk	→
Operational risk	↑
Profitability & solvency	→
Structural risk	↑

Source: *BOU*

5. Outlook for Financial Stability and Policy Stance

Near-term risks to financial stability arising from the pandemic have been relatively contained through timely BOU policy measures. However, the outlook remains highly uncertain and depends on the evolution of the pandemic and the pace of economic recovery.

During this period, policy must be directed at ensuring that banking institutions **help to absorb but not amplify the pandemic shock, a**s highlighted in the June 2020 *Report.*

Accordingly, BOU shall maintain the macro-prudential measures instituted since April 2020 to alleviate shocks to financial system stability, including:

i. Exceptional permission to banking institutions to provide credit relief to borrowers affected by the pandemic, for 12 months effective 1st April 2020. Relatedly, BOU shall continue to enhance public awareness of the credit relief program.

ii. Exceptional liquidity assistance for banking institutions that have or may come under liquidity distress.

iii. 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.

iv. Deferment of payment of discretionary distributions shall continue until further notice, subject to the following;

- First, in August 2020, BOU allowed banking institutions that had not yet paid staff bonuses, which amounted to only USh.12.9 billion for 2019, to do so.

- Secondly, BOU *may* allow banking institutions to pay dividends for 2019 which amounted to USh.436.3 billion (US$118.72 million), subject to the financial institutions submitting a satisfactory forward-looking internal capital adequacy and liquidity assessment that demonstrates that the banking institution has adequate resilience to absorb losses from an adverse scenario. The payment of deferred dividends shall be considered on a case-by-case basis.

BOU shall, pursuant to the financial stability mandate, continue to closely assess the emerging risks to financial stability, including enhanced monthly and weekly monitoring of credit risk and liquidity risk respectively and implement remedial measures in order to safeguard financial sector stability.

6. APPENDIX

6.1. Selected financial soundness indicators for Commercial banks

	Sep-17	Sep-18	Sep-19	Sep-20
Capital Adequacy (%)				
Total capital/RWA (percent)	23.81	21.62	21.36	22.51
Core capital/ RWA (percent)	21.54	19.76	19.62	20.89
NPLs less specific provisions–to–capital	12.59	7.67	7.20	8.86
Leverage ratio	11.30	11.43	11.02	11.28
Asset quality (%)				
NPLs to total gross loans	7.24	4.71	4.35	5.15
NPLs to total deposits	4.63	3.14	2.79	3.11
Specific provisions to NPLs	45.03	50.11	48.26	43.46
Earning assets to total assets	70.93	69.04	72.54	69.83
Earnings & profitability (%) (YoY)				
Return on assets	1.49	2.84	2.81	2.58
Return on equity	8.66	16.30	16.09	15.12
Net interest margin	11.79	11.34	11.24	10.45
Yield on advances	16.27	15.58	15.80	15.24
Cost of deposits	3.00	2.36	2.47	2.47
Cost–to–income	82.85	72.62	72.23	74.26
Liquidity (%)				
Liquid assets–to–total deposits	48.32	43.92	50.29	48.77
Liquid assets–to–total assets	33.14	30.58	34.99	34.34
Interbank borrowings to total deposits	2.11	1.92	1.45	2.46
Market Sensitivity (%)				
Forex exposure to regulatory tier 1 capital	(5.48)	(5.02)	2.43)	(7.48)
Forex loans–to–forex deposits	70.77	67.80	62.76	62.15
Forex assets–to–forex liabilities	90.61	98.45	86.53	95.65

Source: *BOU*

6.2. Selected financial soundness indicators for credit institutions

	Sept-2017	Sept-2018	Sept-2019	Sept-2020
Capital Adequacy				
Core capital/RWA (percent)	22.9	20.3	21.1	20.8
Total capital/RWA (percent)	24.4	21.9	22.7	22.1
Provisions (specific) –to–core capital (percent)	6.2	7.7	6.4	9.5
Asset Quality				
Total provisions (USh. billion)	7.9	10.9	16.5	19.9
Non-performing loans (USh. billion)	11.1	12.3	24.2	30.8
Non-performing loans-to-total loans (percent)	3.9	3.3	3.9	5.3
Profitability (12 months ending September)				
Profit/loss (USh. billion)	-0.1	9.4	14.3	-5.5
Return on Assets (ROA)	0.0	1.5	1.5	-0.6
Return on Equity (ROE)	-0.1	8.5	7.4	-3.0
Liquidity				
Total public deposits (USh. billion)	343.5	440.0	475.1	553.6
Liquid assets–to–deposits (percent)	48.5	42.9	47.0	57.0
Loans–to–deposits (percent)	72.3	75.0	125.8	101.9

Source: *BOU*

6.3. Selected financial soundness indicators for Microfinance Deposit-taking Institutions

Indicator	Sept-2017	Sept-2018	Sept-2019	Sept-2020
Capital Adequacy				
Core capital/RWA (percent)	37.8	43.1	39.8	35.9
Total capital/ RWA (percent)	41.6	46.7	42.6	38.6
Specific provisions–to–core capital (percent)	1.5	1.1	0.6	8.2
Asset Quality				
Total provisions (USh. billion)	12.1	10.6	11.8	20.6
Non-performing loans (USh. billion)	14.1	12.4	12.9	36.4
Non-performing loans–to–total loans (percent)	5.1	4.3	3.7	8.9
Provisions–to–Non-performing loans (percent)	86.0	85.4	91.4	56.7
Profitability				
Profit/loss (year to date) (USh. billion)	12.7	15.2	19.6	13.8
Return on Assets (YTD, Annualised) (percent)	2.9	3.2	3.6	2.6
Return on Equity (YTD, Annualised) (percent)	9.0	9.7	10.9	9.3
Liquidity				
Total deposits (USh. billion)	203.8	222.4	256.4	357.9
Liquid assets–to–deposits (percent)	62.5	67.5	62.4	67.1
Liquid assets–to–total assets (percent)	27.3	30.1	27.0	32.6
Loans–to–deposits (percent)	71.4	80.1	78.9	76.8

Source: *BOU*