FINANCIAL STABILITY REPORT

JUNE 2020

Bank of Uganda

FINANCIAL STABILITY REPORT

June 2020 | Issue No. 12

Address: 37–45 Kampala Road

Postal: P.O. Box 7120, Kampala

Tel: +256 414 258 441-6

Fax: +256 414 233 818

Email: info@bou.or.ug

Web: www.bou.or.ug

ISSN print: 2079-6293

ISSN web: 2079-6307

Comments and enquiries relating to this *Financial Stability Report* should be addressed to:

Director Financial Stability Department

Bank of Uganda

P O Box 7120

Kampala, UGANDA.

Tel. +256417303400

Email: info@bou.or.ug

TABLE OF CONTENTS

GLOSSARY

ALSI	All Share Index
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BOU	Bank of Uganda
CAR	Capital adequacy ratio
CBR	Central bank rate
CI	Credit institution
COVID-19	Severe Acute Respiratory Syndrome coronavirus 2 (SARS-CoV-2)
DPF	Deposit Protection Fund of Uganda
EAC	East African Community
ECS	Electronic clearing system
EFT	Electronic funds transfer
EMDEs	Emerging markets and developing economies
EMEs	Emerging market economies
EUR	European Union euro
FIA	Financial Institutions Act
FMI	Financial market infrastructure
FSR	Financial Stability Report
GBP	Great British pound sterling
GDP	Gross domestic product
GWP	Gross written premium
HHI	Herfindahl-Hirschman Index
HMO	Health management organisation
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IRA	Insurance Regulatory Authority of Uganda
KES	Kenyan shilling
KYC	Know Your Customer
LCI	Local counter index
LCR	Liquidity coverage ratio
LTV	Loan-to-value
MDI	Microfinance deposit-taking institution
MNO	Mobile network operator
NPAT	Net profit after tax
NPL	Non-performing loan
RHS	Right-hand side
ROA	Return on assets
ROE	Return on equity
RPPI	Residential property price index

RTGS	Real-time gross settlement
SFI	Supervised financial institution
SOP	Standard operating procedure
SSA	Sub-Saharan Africa
TZS	Tanzanian shilling
UGX	Uganda shilling
UMRA	Uganda Microfinance Regulatory Authority
UNISS	Uganda National Interbank Settlement System
URBRA	Uganda Retirement Benefits Regulatory Authority
USD/US$	US dollar
USE	Uganda Securities Exchange
WEO	World Economic Outlook

LIST OF TABLES

LIST OF CHARTS AND FIGURES

A NOTE ON FINANCIAL STABILITY

The Bank of Uganda's mandate is to foster macroeconomic and financial system stability. A stable financial system is one in which financial institutions carry out their normal function of intermediating funds between savers and investors, and facilitating payments. By extension, financial instability is a systemic disruption to the intermediation and payments processes, which has damaging consequences for the real economy.

Financial stability analysis involves a continuous assessment of potential risks to the financial system and the development of policies to mitigate these risks. The early detection of risks to the financial system is necessary to give policy makers sufficient lead-time to take pre-emptive action to avert a systemic crisis.

The *Financial Stability Report* (FSR) is intended to enhance the understanding of financial system vulnerabilities among policymakers, financial market participants and the general public. By making the FSR available to the public, the Bank aims to stimulate debate on policies necessary to manage and mitigate risks to the financial system. A better public awareness of financial system vulnerabilities may itself serve to encourage financial institutions to curb activities that might exacerbate systemic risks and will also help to promote policy reforms to strengthen the resilience of the financial sector.

FOREWORD AND ASSESSMENT OF FINANCIAL STABILITY

The *Financial Stability Report* (FSR) of the Bank of Uganda (BOU) provides an assessment of the main systemic risks to the financial system and analyses the performance and condition of Ugandan financial institutions. In addition to the banking system, the FSR also presents an assessment of developments in financial market infrastructure, capital markets and insurance institutions.

The overall assessment of the FSR is that threats to the systemic stability of the financial system increased in the year to June 2020, principally attributed to the impact of the COVID-19 pandemic on global and domestic economic activity. The pandemic and the necessary measures to contain the spread of the virus adversely affected domestic economic activity, which affected the financial condition of households and businesses, with a knock-on effect on credit, liquidity and operational risks in the banking system.

BOU decisively intervened with monetary and macroprudential policy measures aimed at safeguarding financial system stability, as well as supporting economic recovery. The objective of these interventions is to enable supervised financial institutions (SFIs) to absorb but not amplify the shock. By June 2020, BOU had implemented the following measures to alleviate the impact of the pandemic on SFIs; giving permission to SFIs to grant credit relief to borrowers affected by the pandemic, setting up a COVID-19 Liquidity Assistance Program (CLAP) for SFIs that may come under liquidity distress, setting a limit on the loan-to-value (LTV) ratio for residential mortgages and land purchase, deferral of payment of dividends, and promotion of digital and cashless payment platforms. Consequently, the measures supported the banking sector in building up and maintaining ample capital and liquidity buffers, over and above the statutory minimum requirements, to cushion them against emerging risks during the pandemic period.

As a result of the measures implemented by BOU, near-term risks to financial stability arising from the pandemic remain relatively contained. Looking ahead, and consistent with the slowdown in economic activity, the outlook for financial stability points to challenging conditions for the banking sector, until economic recovery picks up and the spread of the virus is contained. BOU stands ready take additional action as the pandemic evolves, in order to address any emerging risks to financial sector stability.

Emmanuel Tumusiime-Mutebile (Prof.)
GOVERNOR

EXECUTIVE SUMMARY

The COVID-19 pandemic has caused an unprecedented shock to economic activity and elevated systemic risks to the stability of Uganda's financial system. Global and domestic economic activity has been severely disrupted by the unprecedented public health crisis and the measures put in place to contain it. Domestic real GDP growth declined from 6.8 percent to 3.1 percent between June 2019 and June 2020. The slowdown in economic activity will continue to negatively affect the financial condition of households and businesses, many of whom will face a significant loss of income. The loss of income will mean that some borrowers will experience difficulty in repaying their loans, with an adverse knock on effect on the financial performance of banking institutions.

Credit risk from declining loan quality remains the main risk to financial stability as weaker economic activity has led to a rise in loan losses. Asset quality worsened through the year ended June 2020, with the industry ratio of non-performing loans to total loans (NPL ratio) for commercial banks rising from 3.8 percent to 5.8 percent, for credit institutions from 4.3 percent to 7.6 percent, and for microfinance deposit taking institutions from 3.9 percent to 10.8 percent. The rise in NPLs could have been higher but was moderated by the credit relief measures issued by Bank of Uganda (BOU) in April 2020. Pressure appears to be most acute in the tourism, education and transport sectors. Many firms in these sectors will face longer recoveries than others as border restrictions and social distancing measures affect their earnings and operating models. Hence, asset quality is likely to deteriorate further in the near term, on account of slow recovery in economic activity and if maturing credit relief remains distressed. BOU's risk modelling forecast the NPL ratio to rise to a range of 6 – 10 percent in the short term, with adverse implications for banks' profitability.

Wholesale funding and liquidity conditions eased in the quarter to June 2020 in line with BOU's monetary and macroprudential policy measures. After initial volatility in the first weeks following the lockdown in March 2020, wholesale funding costs eased and the spreads between the interbank rates and the policy rates reduced. Nevertheless, there remained bank-specific liquidity stress. In June 2020, one commercial bank accessed UGX.20 billion from the COVID-19 Liquidity Assistance Program (CLAP). In July 2020, one credit institution applied for UGX.2 billion, and another commercial bank borrowed UGX.40 billion from the Lombard Window. In response, BOU established a Standing Lending Facility (SLF) in July 2020 which is aimed at addressing bank-specific liquidity needs in day-to-day operations. However, a gap remains for SFIs that may progress from normal liquidity shortfalls to severe liquidity distress. As a solution, the Bank shall soon operationalise the Emergency Liquidity Assistance (ELA) Framework to address this gap.

The pandemic has heightened operational risks in the banking system, due to the emergence of unprecedented business continuity requirements for financial institutions and the potential for the lockdown of head offices and branch locations if a COVID-19 infection occurs. During the quarter ending June 2020, over half of the financial institutions' branches were closed and/or had shorter operating hours. Secondly, the pandemic led to greater reliance on cashless/digital payment channels such as online banking. For example, active users on internet and mobile banking platforms grew notably by 36.7 percent and 46.9 percent respectively during the same period. However, the enhanced usage of digital systems has increased the potential for cyber-related threats.

In order to address the aforementioned operational risks, BOU directed all supervised financial institutions (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 suspended 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 for financial services over the short- to medium-term.

Macro stress tests conducted by BOU to assess banks' ability to absorb losses suggest that despite the uncertainty regarding the economic outlook, most SFIs including the domestic systemically important banks (DSIBs), are resilient to a broad range of adverse economic scenarios. Bank resilience will however be tested in the coming months in the event that loan losses rise materially from current levels. In the meantime, on aggregate, banks have strong capital and liquidity buffers to withstand the COVID-19 shock. These buffers have increased strongly over the past decade in response to the enhanced supervisory and regulatory framework. Nevertheless, rising provisions for bad loans are likely to erode profitability, particularly in those banking institutions that had weak buffers before the pandemic.

BOU policy measures have aimed at ensuring that SFIs help to absorb but not amplify the shock. Consequently, BOU has taken decisive measures to safeguard financial stability and alleviate the impact of the COVID-19 pandemic on economic growth, and these measures have been effective.

a) Provided exceptional permission to SFIs to provide credit relief to borrowers affected by the pandemic during the 12 months effective April 1 2020. The total loans restructured in April, May, June and July 2020 amounted to UGX.5.9 trillion, which is equivalent to 31.7 percent of total loans.
b) Set up an exceptional liquidity assistance facility for SFIs that may come under liquidity distress, including credit institutions and MDIs which did not have access to BOU lending facilities. Two SFIs have applied for UGX.21 billion of liquidity support under the facility.
c) Set a limit of 85 percent on the LTV ratio of loans for residential mortgages and land purchase, effective June 1 2020, in order to address credit risk from a potential reduction in property prices.
d) Directed SFIs to defer payment of dividends and other discretionary payments in order to build up capital and liquidity buffers during this period. The total deferred bonuses and dividends amount to UGX.12.4 billion and UGX.436.3 billion (US$118.72 million) respectively.
e) Directed SFIs to leverage and promote the use of digital platforms and cashless transactions, in cooperation from the Mobile Network Operators in order to minimize human interaction.

BOU also implemented and continues to undertake enhanced monthly and weekly monitoring of key risks, including credit risk and liquidity risk.

The outlook for financial stability points to challenging conditions for the banking sector going forward. This is mainly driven by the COVID-19 pandemic impact and duration of the shock thereof, on economic activity and credit risk. On balance, systemic risks are likely to remain elevated in the near term until economic recovery is stronger. BOU stands ready take additional action, if needed to address any emerging risks to financial sector stability.

A. THE MACROFINANCIAL ENVIRONMENT

The rapid escalation of the COVID-19 pandemic and the containment measures put in place to suppress the spread of the virus has led to a major slowdown in economic activity around the world and in Uganda's economy, with adverse implications for the financial condition of households and businesses. The Government and Bank of Uganda (BOU) initiatives have supported the economy, and while the duration of the pandemic remains uncertain, the outlook for macrofinancial conditions is dependent on the pace of economic recovery.

1. Global macroeconomic developments

Globally, government-imposed containment measures to suppress the spread of the virus saw closures of a broad range of commercial activities. As a result, global economic activity weakened (Chart 1) with the International Monetary Fund (IMF) projecting that global economic growth will contract by 4.9 percent in 2020, worse than their April 2020 forecast of -3.0 percent[1]. Growth in advanced economies is projected at -8.0 percent in 2020, whereas overall, growth in emerging market and developing economies is forecast at -3.0 percent in 2020. Furthermore, it is projected that global trade will suffer a deep contraction in 2020 of -11.9 percent, reflecting considerably weaker demand for goods and services and disruptions to global supply chains. The emergence of the pandemic came on the back of a global economic slowdown that was experienced in the second half of 2019, amid growing tensions between the United States and China on trade and technology, and a slowdown in demand in China partly reflecting regulatory efforts to rein in debt. For the first time, all major economic regions are projected to experience negative growth in 2020.

Chart 1: Quarterly changes in global GDP (percent, 2019:Q1=100)

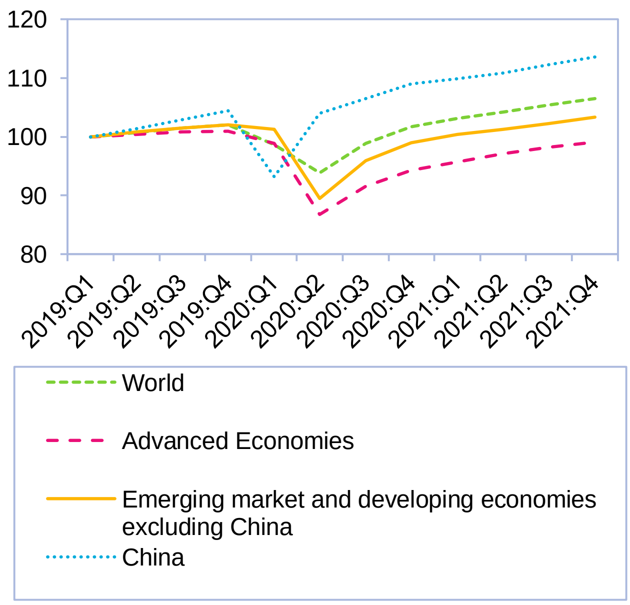
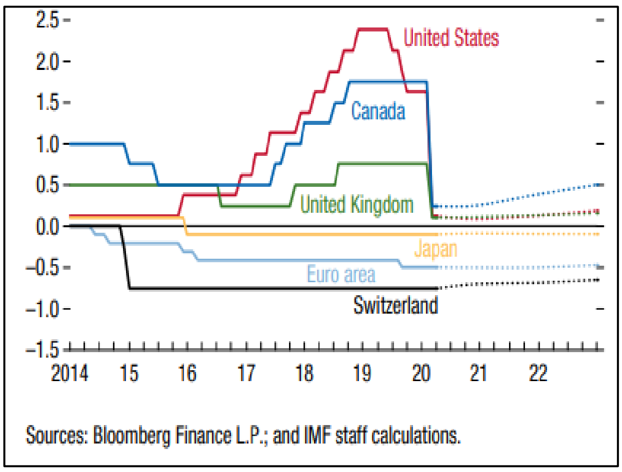


Chart 2: Actual and expected policy rates for advanced economies (percent)



Source: International Monetary Fund

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

The global policy response has been quick, focused on providing temporary liquidity support, particularly to the most affected firms and individuals, as well as accommodative monetary and fiscal policy. Nevertheless, going forward, considerable uncertainty remains, regarding the duration and magnitude of impact of the pandemic. Social distancing, travel restrictions, and income losses mean that global economic activity is likely to remain depressed for some time.

2. Developments in the East African Region

2.1. Overview of regional macroeconomic conditions

The East African Community (EAC) region, which is comprised of Burundi, Kenya, Rwanda, South Sudan, Tanzania and Uganda, has also borne the impact of the COVID-19 pandemic. Containment measures have led to a slowdown in economic growth across the region, with GDP growth in the second quarter of 2020, falling to the lowest level seen since December 2014 (Table 1). The EAC region provides a strong market for Ugandan firms, and hence the decline in regional economic activity and resulting cross-border spill-overs are likely to continue affecting the financial condition of companies in Uganda until the pandemic is contained.

Table 1: Real GDP growth rates in the EAC region (percent)

YEAR	2016	2017	2018	2019	Mar-20	Jun-20	2020 - Projected
Burundi	-1.0	0.0	1.4	0.4	N/A	N/A	N/A
Kenya	5.9	4.9	6.0	5.8	4.9	-5.7	3.5
Rwanda	6.0	6.2	8.6	7.8	3.6	-12.4	2.0
Tanzania	6.9	6.8	6.6	4.0	5.7	5.7	5.5
Uganda	2.3	5.0	6.2	6.3	5.3	3.1	3.5

Source: EAC Partner State Central Banks

In the near term, the accommodative monetary policy adopted by the EAC Partner States in the year to June 2020 (Table 2) and fiscal policy measures are expected to support economic recovery and boost regional trade. The easing of monetary policy across the EAC region was partly aided by subdued inflation pressures, which reflected the low global oil prices and conducive weather conditions that boosted crop production across the region (

Table 3). Except for Kenya whose average headline inflation for the year to June 2020 was 8.7 percent, other Partner States recorded stable inflation, with Uganda's inflation rate at 6.3 percent, Tanzania with 3.2 percent, while Burundi recovered from a period of deflation in 2019.

Table 2: EAC Central Bank monetary policy rates (percent)

YEAR	2016	2017	2018	2019	Mar-20	Jun-20
Burundi	N/A	2.8	2.4	3.0	2.6	3.0
Kenya	10.0	10.0	9.0	8.5	7.3	7.0
Rwanda	6.3	5.5	5.5	5.0	5.0	4.5
Tanzania	12.0	12.0	7.0	7.0	7.0	5.0
Uganda	12.0	9.5	10.0	9.0	9.0	7.0

Source: EAC Partner State Central Banks

Table 3: Annual average headline inflation in the EAC region (percent)

YEAR	2016	2017	2018	2019	Mar-20	Jun-20
Burundi	7.5	14.2	-7.1	-0.8	1.8	4.7
Kenya	6.5	4.5	5.7	5.8	4.6	4.2
Rwanda	7.0	2.2	0.2	6.0	8.2	8.7
Tanzania	5.0	4.0	3.3	3.8	3.4	3.2
Uganda	5.5	2.1	8.4	5.7	6.4	6.3

Source: EAC Partner State Central Banks

However, the fiscal expansion to combat the pandemic has accelerated a rise in the level of public debt in the region amidst a decline in revenues. As at end-June 2020, Kenya's public debt–to–GDP ratio was the highest in the region at 65.7 percent, while the ratios for Uganda, Tanzania and Rwanda stood at 40.8 percent, 42.1 percent, and 49.0 percent, respectively. A significant share of this debt is held by domestic commercial banks in some countries in the region. For example, in Uganda, as at end-June 2020, banks' holding of Government of Uganda (GOU) debt had increased to 38.2 percent of total domestic debt, which represented 21.4 percent of banks' total assets. In addition, the ratio of GOU debt to private sector credit increased to 112 percent. Overall, there is a risk that rising government debt may not only crowd out private sector credit going forward, but also constrain the fiscal space, leaving governments in the region not well positioned to provide further fiscal support for the recovery, a factor that will be crucial to maintaining financial stability.

2.2. Stability and performance of the banking sector in the region[2]

The banking system in the EAC region remains in a strong position to continue supporting the economy through this downturn. Total assets of the banking institutions in the EAC grew by 8.9 percent to reach the equivalent of US$79.2 billion as at June 2020 from US$72.9 billion as at June 2019. The composition of assets is largely in the form of loans accounting for 46.8 percent, followed by government securities accounting for 20.0 percent of the total assets. Banks across the region continued to provide credit to the private sector, with annual loan growth of 22.4 percent in Burundi, 14.6 percent in Rwanda, and 13.0 percent in Uganda. The bulk of this credit was mainly for working capital to firms, government budget support, and industrialisation projects. However, on a quarterly basis, credit growth slowed down in the quarter to June 2020, reflecting the impact of the pandemic, and it remains below its historical trend.

Banks in the EAC region have largely remained resilient to the pandemic, with adequate capital and liquidity positions boosted by strong profitability and deposit growth respectively, during the year to June 2020. All countries in the region, except for Tanzania, registered an increase in capital, with the ratio of total regulatory capital to risk-weighted assets as at end-June 2020 reported at 22.7 percent for Uganda, 18.5 percent for Kenya, 17.9 percent for Tanzania, 23.6 percent for Rwanda, and 26.2 percent for Burundi, respectively. This was well above the harmonised EAC regional regulatory minimum of 12 percent. Bank profitability as measured by the average return on assets (ROA) improved particularly in Tanzania and Rwanda from 2.0 percent to 2.2 percent and 2.6 percent to 2.7 percent respectively due to an increase in operating income and efficiency gains.

[2] The data for the regional comparison presented in this section is available in Appendix 4 of this Report.

In addition, on aggregate, the liquid assets-to-total deposits ratios for all countries in the region were above the EAC regional harmonised regulatory requirement of 20.0 percent, except for Burundi where the aggregate indicator was 15.5 percent. This is an indication that a significant number of banks in Burundi were facing liquidity challenges as at the end of June 2020. The rise in liquid assets partly reflected significant increases in the stock of retail deposits, owing to increased mobilisation of deposits through digital platforms, increased use of agent banking, and the preservation of liquidity in light of the pandemic.

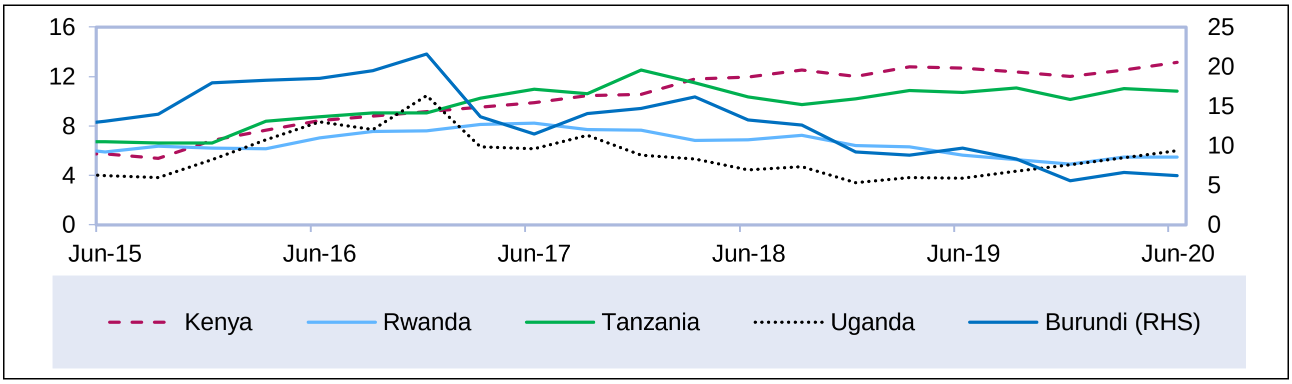
Table 4: Selected aggregate banking sector indicators for the EAC region as at end-June 2020 (percent)

	Burundi	Kenya	Rwanda	Tanzania	Uganda
Annual credit growth	22.4	7.9	14.6	4.2	13.0
Quarterly credit growth	8.0	2.6	2.5	2.2	0.2
Restructured loans/total loans	21.0	29.8	39.0	0.6	30.9
Average lending rate (domestic currency)	15.4	12.1	15.1	16.5	18.3
Average return on assets	2.1	2.3	2.7	2.2	2.6
Core capital/risk-weighted assets	28.7	16.4	22.3	16.9	21.2
NPL ratio	6.2	13.1	5.5	10.8	5.8

Source: EAC Partner States Central Banks

Nevertheless, the economic impact of COVID-19 has affected the liquidity position of some banks and resulted in worsening of loan quality across the region. As the effects of the pandemic led to deterioration in the balance sheets of households and business, banks' ratios of non-performing loans to total loans (NPL ratio), rose in Kenya, Uganda and Tanzania. Kenya and Tanzania registered double digits of increases of 13.1 percent and 10.8 percent respectively (Table 4 and Chart 3). Rwanda and Burundi recorded a decline in their NPL ratios, from 5.6 percent to 5.5 percent and 9.7 percent to 6.2 percent respectively. The observed trend largely reflected a higher write-off rate for bad loans and an increase in recapitalised interest on restructured loans.

Chart 3: Aggregate ratio of NPLs to total loans in the EAC region's banking sectors (percent)



Source: EAC Partner State Central Banks

2.3. Policy responses to COVID-19 effects in the EAC region

During the year to June 2020, authorities in the EAC region deployed fiscal, monetary and macroprudential measures aimed at mitigating the economic effects of the pandemic and enabling the banking institutions to remain resilient. The macroprudential policy responses that were implemented and their status are as follows:

a) ***Permitting banks to provide loan repayment holidays and restructuring to borrowers affected by the pandemic***. With the exception of Burundi, all countries in the region implemented temporary credit relief programs in order to mitigate the effects of the pandemic on bank loan performance which, while leading to a rise in restructured credit facilities, also moderated the rise in NPLs from the private sector. As at end-June 2020, Rwanda had the highest ratio of restructured loans to total loans of 39.0 percent, while Tanzania's ratio was the lowest at 0.6 percent (Table 4).

b) ***Setting up liquidity assistance facilities for distressed banking institutions***. All Partner States provided various liquidity facilities, including longer tenor reverse repurchase orders, reduced cash reserve requirements (CRR), new standing facilities, easing of capital requirements, and emergency liquidity assistance.

c) ***Promoting the use of digital payments platforms*** in order to maintain financial intermediation during the periods of restricted movements and minimise the spread of COVID-19.

Going forward, the measures put in place by authorities are expected to continue supporting financial sector stability across the region. However, this outlook is subject to the pace of economic recovery. In Kenya, the removal of interest rate capping[3] is expected to increase credit supply to the private sector even though it may have heightened credit risk implications over the short term.

3. Domestic macrofinancial impact of COVID-19

The immediate and direct consequences for the Ugandan economy from the COVID-19 pandemic and the preventive measures taken, both globally and at home, have been largely on the downside. While the initial shock from the national lock down in the period March 2020 – May 2020 has started to pass, the Ugandan economy is operating well below its productive capacity. Uganda's real gross domestic product (GDP) declined by 3.2 percent in the quarter ended June 2020 and on annual basis, growth reduced from 6.8 percent to 3.1 percent between June 2019 and June 2020.

Chart 4: Quarterly changes in domestic real GDP

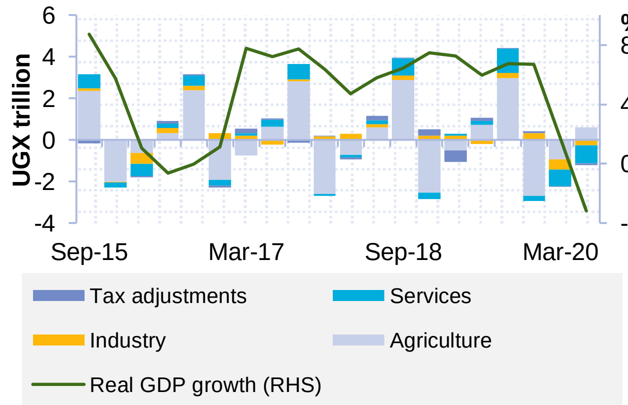
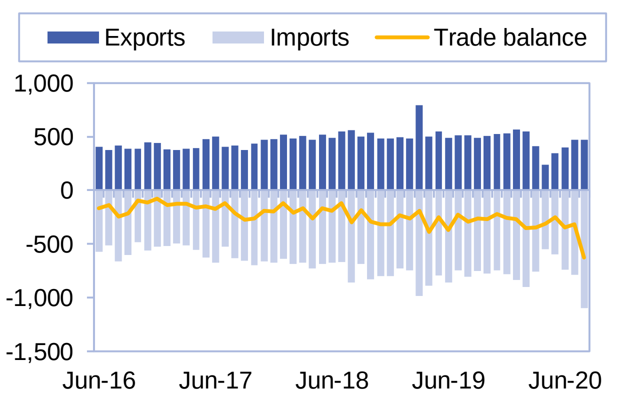


Chart 5: Uganda's trade activity (US$ million)



Source: Bank of Uganda

The volatility in global financial markets which occurred at the onset of the pandemic spread to the domestic markets and brought a sharp but temporary reversal in offshore investor flows. As the effect of the pandemic

[3] Source: https://www.businessdailyafrica.com/news/Rate-cap-ends-after-House-quorum-hitch/539546-5338346-beb1p9z/index.html

intensified in March 2020, liquidity conditions in the financial sector tightened and costs of borrowing in the interbank increased amidst investor uncertainty and risk aversion (see Section B.1 for a detailed analysis of interbank funding conditions). Offshore investor outflows in Uganda rose, partly undertaken by borrowing shillings in the foreign exchange swap market ostensibly to purchase foreign currency and exit, which would be paid back later at maturity using their Treasury bill holdings. By April 15, 2020, offshore investors had borrowed UGX.456 billion through swaps. These developments, coupled with market uncertainty, exacerbated exchange rate volatility as depicted by the 30-day moving standard deviation on the exchange rate, resulting in a sharp depreciation in February and March 2020 (Chart 6). BOU took action to address the exchange rate volatility and enhance market confidence, and indicators also show that volatility in the flow of foreign investor funds stabilized in the quarter to June 2020**.** The flexible exchange rate helped to cushion any depreciation effects on the financial sector and commodity exporters, by adjusting accordingly, supported by donor budget support, inflows from offshore investors, and increased export revenue.

Chart 6: Movements in the UGX/USD exchange rate (UGX)

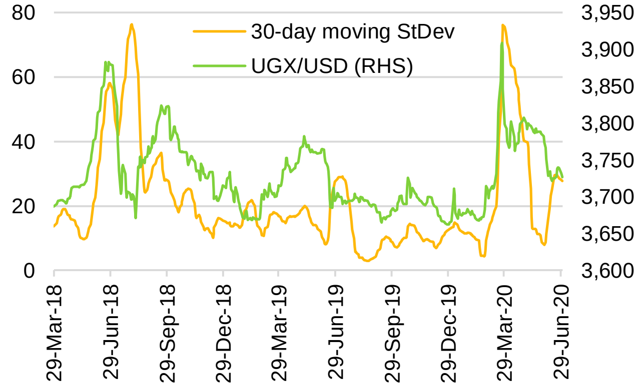
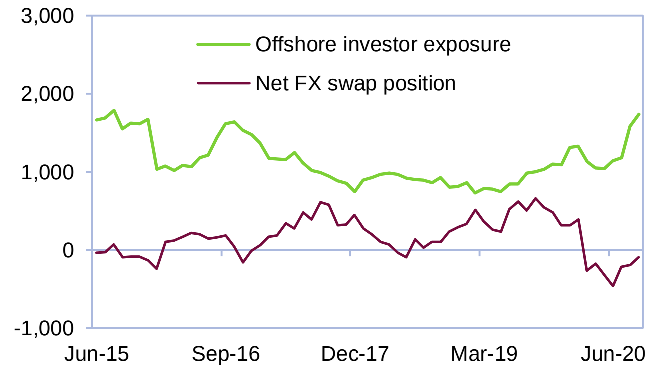


Chart 7: Offshore investor activity in the domestic financial markets (UGX. billion)



Source: Bank of Uganda

On a sector by sector basis, the impact of the shock and resilience thereto, varied widely across sectors and depended largely on the impact of restrictions imposed to mitigate the spread of the virus on their business activities. The impact of the pandemic was most significant for firms in trade, transportation, education and tourism (the services sector), whose contribution to GDP reduced by UGX.715.5 billion in the year to June 2020, compared to an increase of UGX.768.4 billion in the previous year to June 2019 (Chart 4).

The export sector faces a challenging outlook that is dependent on the recovery of demand in export markets, and in domestic consumption. While Uganda's trade deficit narrowed by 16.0 percent during the quarter ended June 2020, the trend partly reflected a decline in imports categories (Chart 5), while border closures and curfew restrictions affected both formal and informal cross border trade[4]. In addition, firms in sectors still under partial lockdown such as the education sector, and those whose viability depends on inbound tourism, face a more prolonged and challenging recovery outlook. On the other hand, the Agriculture sector has fared relatively well and seems to have weathered the shock relatively better and registered growth during the quarter ended June 2020 amounting to UGX.604.9 billion. However, commodity specific vulnerabilities in the sector remain. The sector is vulnerable to income shocks given its dependence on global commodity prices which are likely to remain subdued until global growth picks up.

[4] Monetary Policy Report, August 2020, Bank of Uganda

Household and personal balance sheets have come under increasing financial stress through two key channels: an increase in unemployment from redundancies and business failures in sectors most directly affected by COVID-19; and reductions in pay as firms across a range of sectors look to offset cash flow pressures during a period of reduced revenue. This is likely to increase debt-servicing burdens despite historically low interest rates.

The residential and commercial property markets have faced vulnerabilities due to the downturn. First, there was concern that household financial stress could be accentuated by declining house prices, which would amplify a reduction in valuation of collateral and potentially negatively impact bank profits. The Residential Property Price Index (RPPI)[5] indicates that property prices in the Greater Kampala Metropolitan Area decreased by 2.9 percent over the quarter ended June 2020, compared to an increase of 5.8 percent registered over the quarter ended March 2020. Secondly, the commercial properties sector, especially accommodation, hospitality, retail, and office properties, have also been affected by international travel restrictions and lockdown measures. Due to a number of unique characteristics, the commercial property sector tends to be pro-cyclical, with many investors being highly leveraged, holding significant maturity mismatches on their balance sheets, and relying on rental income to service debt[6]. Anecdotal evidence shows that many property owners have proactively offered rent reductions to support tenants during the downturn, but a prolonged economic slump could put downward pressure on rents and lead to increases in vacancy rates.

The impact of falling property prices on banking institutions' collateral values was alleviated by prudent loan-to-value (LTV) ratios maintained by commercial banks, which remained below the limit of 85 percent on residential mortgages and land purchase loans that was set by BOU in May 2020. This has been a positive outcome for financial stability since borrowers and banks are generally now able to absorb a greater decline in property prices without having borrowers going into a negative equity situation. As a result, fewer non-performing housing loans and foreclosures are expected, further reducing the likelihood of a negative feedback loop that could further depress property prices.

The banking system is exposed to significant risks, the majority of which are from the sectors hardest hit by the COVID-19 pandemic. Analysis of lending by sector (*see Chart 17 and Chart 18 under the next chapter*) shows that as at end of June 2020, commercial banks were mostly exposed to the real estate, household, and trade sectors. For these three sectors, the exposure on aggregate accounted for 54.4 percent of total loans and advances across the banking industry. It is inevitable that any vulnerability in these sectors is likely to exacerbate the economic downturn and weaken the banking sector's resilience. Banks have supported the hardest hit economic sectors through implementation of the BOU credit relief programme, which is explained further in the next chapter of this Report. However, if borrowers' financial distress persists over a longer period than expected, the above trend could adversely affect bank profitability and capital.

4. Conclusion

The global and domestic economic outlook and the implications for financial sector stability remain uncertain, largely because of the unpredictable severity and duration of the pandemic. Looking ahead, domestic economic activity and revenues in most sectors are expected pick up with the lifting of public health measures

[5] Uganda Bureau of Statistics, Residential Property Price Index (RPPI) Q4 2019/20 Press Release; Website: https://www.ubos.org/wp-content/uploads/publications/07_20204th_Quarter_2019-20_Report.pdf

[6] Reserve Bank of New Zealand, Financial Stability Report, May 2020

and the expected uptick in local and global demand. Indicatively, high frequency indicators of domestic economic activity[7] point to a recovery during July and August 2020, and BOU projects Uganda's economy will grow at a rate in the range of 3.0 percent to 4.0 percent in the financial year 2020/21.

Nonetheless, vulnerabilities remain in several sectors, reflecting potential headwinds to economic recovery and financial stability, which could be amplified by a prolonged pandemic or further lockdowns. Businesses and household resilience to these headwinds will depend on their financial strength coming into this economic downturn as well as the extent of their exposure to the different channels of the shock. However, on aggregate the banking sector is well capitalised to absorb losses from the aforementioned scenario.

[7] IHS Markit Purchasing Managers' Index, April 2020

B. PERFORMANCE OF THE BANKING SECTOR

The financial landscape in Uganda is dominated by the banking sector which accounts for 83 percent of the assets in the financial system. It is important that banks help to absorb but not amplify the COVID-19 shock. On aggregate, banks have adequate capital and liquidity buffers which they can draw on to cover potential losses and support households and businesses that are facing temporary distress but are viable. Nevertheless, a few banks that entered the pandemic period with weak buffers may come under stress if the downturn in economic activity is prolonged.

1. Market funding and liquidity conditions

1.1. Liquidity buffers

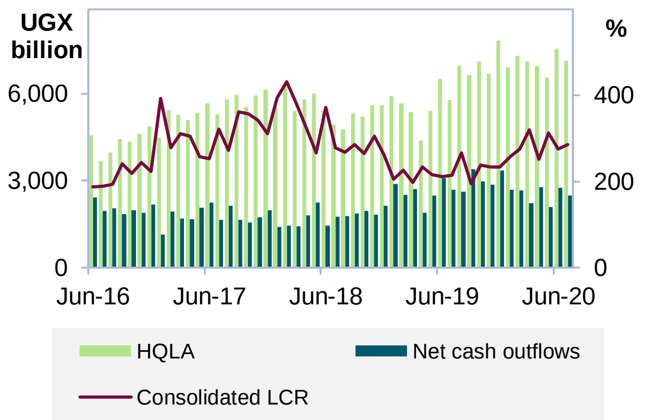
Banks have strong liquidity buffers, including all systemically important banks (DSIBs), enhancing their resilience to liquidity risk. Liquidity buffers refer to banks' stocks of liquid assets such as: cash, central bank reserves, deposits with other banks, and/or government securities; all of which are easily converted into cash to meet unexpected cash outflows needs.

The ratio of liquid assets-to-total deposits increased for all banking institutions and was well above the regulatory minimum of 20 percent for banks and credit institutions, and 15 percent for microfinance deposit-taking institutions (MDIs). The aggregate consolidated liquidity coverage ratio (LCR) shows that except for one bank, all banks were able to meet the 100 percent minimum requirement on a consolidated basis (all currencies) as at the end of June 2020, and thus held sufficient high quality liquid assets (HQLAs) to meet their net cash out flows over the subsequent 30 days. Overall, banks entered the pandemic having built up strong liquidity positions in the last few years, partly on account of the prudential standards introduced by BOU particularly, the LCR, aimed at ensuring that banks have stable funding bases available to meet cash outflow needs.

Table 5: Liquid assets-to-deposits ratio (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

Chart 8: Consolidated liquidity coverage ratio for commercial banks (percent)



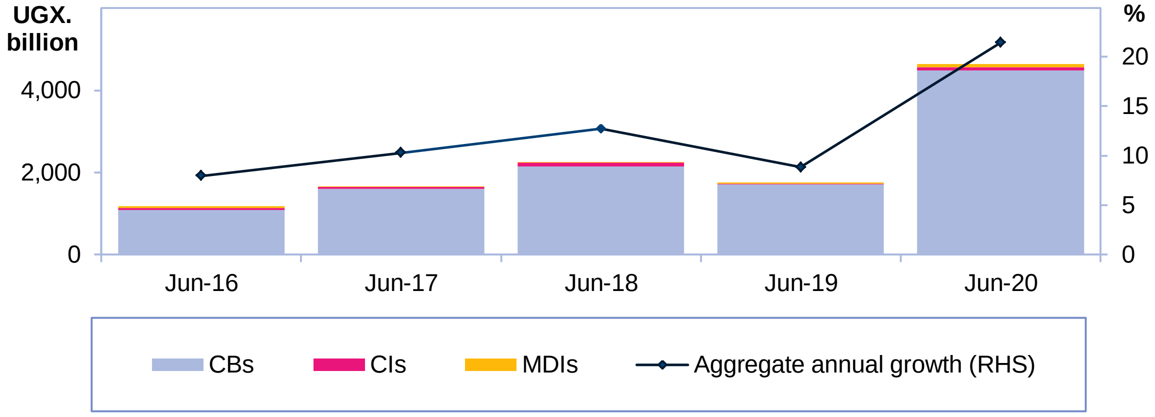
Source: Bank of Uganda

The rise in liquidity buffers also partly reflected increased cash balances and investment in government securities, as well as banks' deposits with non-resident banks during the pandemic. The growth rate of deposits in non-resident banks increased from 16.4 percent in June 2019 to 39.5 percent to reach UGX.3.1

trillion in the year ended June 2020, with the largest increase witnessed during the quarter ended March 2020 following the outbreak of the COVID-19 pandemic. This was partly fuelled by 'flight to safety' trends in global financial markets. A significant portion of these funds have since returned to the domestic market, and it is expected that banks will draw on these liquidity buffers to support provision of credit to households and businesses during the economic recovery.

The build-up in liquidity buffers was supported by strong net inflows of customer deposits during the year to June 2020 and more so in the second half of the period, which provided a more stable form of funding. Aggregate deposits grew by 21.4 percent during the period under review to reach UGX.26.3 trillion, up from a growth rate of 8.8 percent in the year to June 2019 (Chart 9). This trend reflects the slowdown in economic activity, and that credit growth has also remained subdued as borrowers have looked to pay down existing debts in the short term and preserve cash assets. Relatedly, the cost of deposits reduced from 2.6 percent to 2.5 percent.

Chart 9: Annual changes in banking sector deposits



Source: Bank of Uganda

Banks are inherently vulnerable to liquidity risk arising from the maturity transformation role they play, that is, the use of short-term liabilities/inflows such as customer deposits to fund longer term assets such as loans. To monitor this risk, BOU embarked on enhanced liquidity monitoring during the pandemic period whereby banks' 'liquidity gap' was computed on a weekly basis and all banks were required to have sufficient liquid assets available to at least match their projected net cash outflows during the upcoming week and month. In the coming months, the credit relief programme that allows customers to defer payment of loans is expected to lead to a decline in banks' liquidity gap, as banks see increasingly lower volumes of cash inflows from deferred loan repayments (see Section B.3), while their cash outflows may increase as the economic recovery picks up.

1.2. Market liquidity

Having strong liquidity buffers and a more stable funding profile allowed banks space to weather the temporary volatility in wholesale funding brought on by the pandemic, supported by BOU monetary and macroprudential policy measures. During March 2020, conditions in the domestic wholesale funding[8] markets deteriorated. Heightened risk aversion at the onset of the lockdown in March 2020 triggered a "flight-to-safety"

[8] Wholesale funding is often quickly withdrawn from banks at the first sign of stress or dislocation in global conditions, or is only available at elevated cost.

move by offshore investors from the domestic market for a brief period. This quickly permeated through funding markets, causing spreads to widen, increased market pressures and idiosyncratic liquidity shortages among a few banking institutions. Credit spreads widened as shown by the spread between the 7-day interbank rate and the central bank rate in Chart 11, significantly increasing the access to and cost of wholesale funding for banks. There were indications of liquidity hoarding, which affected the efficiency of the interbank market in the six months to June 2020. This led to the increase in the weighted 7-day interbank rate to 9.3 percent in the quarter ended March 2020 which then eased to 7.7 percent during the quarter ended June 2020.

Chart 10: Maturity breakdown of activity in the domestic shilling financial market (UGX. billion)

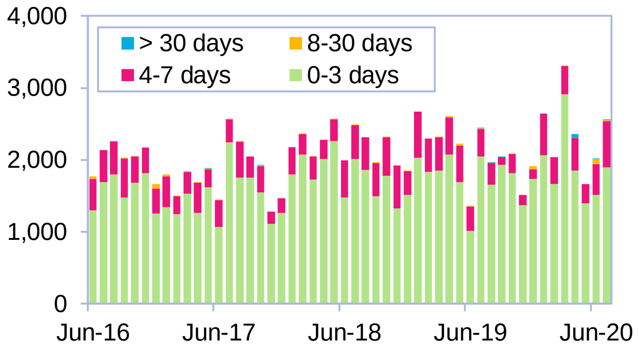


Chart 11: Spreads between 7-day domestic interbank rates and the central bank rate (percent)

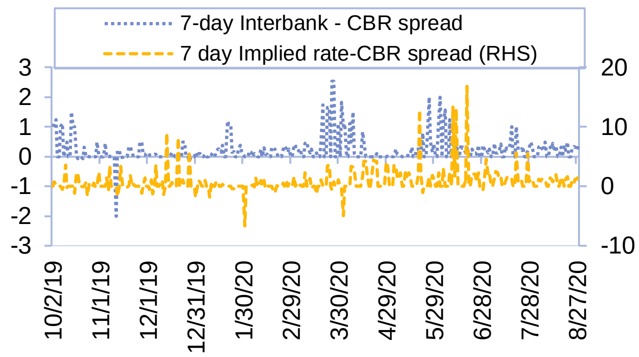


Chart 12: Activity in the domestic foreign currency swap market (UGX. billion)

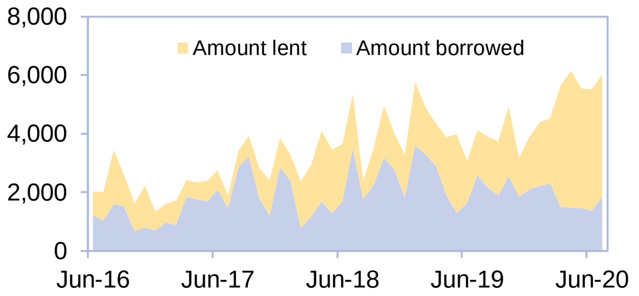
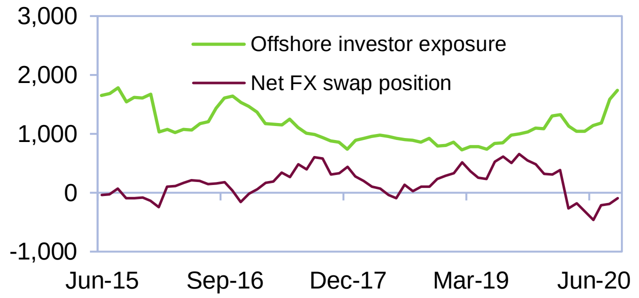


Chart 13: Offshore investor activity in the domestic financial markets (UGX. billion)



Source: Bank of Uganda

Foreign investors' position in the domestic foreign currency swap market changed from a net receivable amount of UGX.320.5 billion to a net payable amount of UGX.462.8 billion, a move by the investors that suggests their desire to capture the relatively higher returns in Uganda as well as hedge their positions for currency risk (Chart 13). In the foreign currency swap market, the total amounts traded increased from UGX.49.5 trillion to UGX.55.6 trillion during the period under review. It should be noted that approximately UGX.22.9 trillion of the traded amount was registered between March and June 2020 (Chart 12).

BOU responded by easing monetary policy and announcing the establishment of liquidity assistance facilities for banks that aimed to: offset the expected tightening in financial conditions; ensure the availability of ongoing liquidity in the financial system; and facilitate market functioning by enhancing banks' ongoing ability to extend credit (*further details provided in Section B.4 of this Report*). As a result, by June 2020, wholesale funding costs eased and market volatility reduced as the spreads between the interbank rates and the CBR reduced. By end-September 2020, offshore investors had reduced their net payable position to UGX92.3 billion and also increased their overall net inflows, indicating improved perception of the direction of risk in the market.

Despite the strong aggregate liquidity buffers and improved wholesale funding conditions, there remain bank-specific funding shortages among a few institutions. In June 2020, one commercial bank accessed UGX.20 billion from the COVID-19 liquidity assistance program (CLAP) that was established by BOU to support banking institutions during the pandemic. In July 2020, one credit institution applied for UGX.2.0 billion but subsequently withdrew its application. Shortly thereafter, a commercial bank borrowed UGX.40 billion from the Lombard Window and this was repaid before the due date.

In order to further address normal bank-specific funding stress, BOU set up a Standing Lending Facility in July 2020. In addition, to effectively provide liquidity assistance to institutions that may progress to liquidity distress, BOU has embarked on setting up an Emergency Liquidity Assistance Framework (ELA) which is expected to be finalised during the financial year 2020/21.

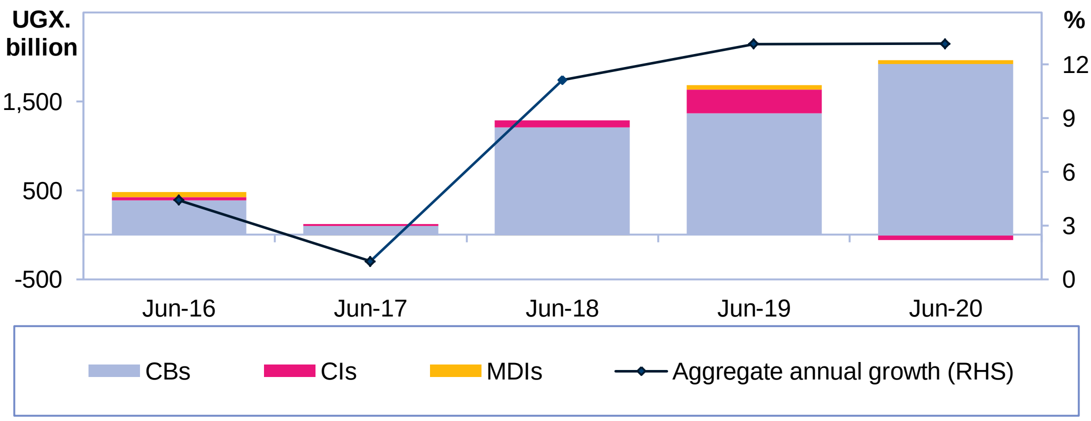
2. Lending and credit risk

2.1. Changes in lending activity

Credit risk in the banking sector increased over the year ended June 2020 and is the main threat to the soundness of banks. The pandemic adversely affected bank lending to businesses and households. On aggregate, total lending by commercial banks rose by 13.2 percent to reach UGX.15.5 trillion during the year to June 2020. This is comparatively similar to the 13.1 percent registered in the year to June 2019 (Chart 14). During the same period ending June 2020, loans by MDIs grew by 14.6 percent, while loans by credit institutions declined by 9.2 percent. This decrease is largely due to Opportunity bank exiting the sub-sector.

Foreign currency denominated loans grew by 16.4 percent (or 15.3 percent when discounted for the foreign exchange rate valuation effects) compared to growth of 12.6 percent for shilling loans. However, private sector credit growth remained subdued in the six months to June 2020, mainly comprised of recapitalised interest from loans restructured due to the pandemic of UGX.328.8 billion, as well as lending to government for budget support which amounted to UGX.667.7 billion.

Chart 14: Annual changes in banking sector loans



Source: Bank of Uganda

Furthermore, debt-servicing by borrowers reduced significantly in the quarter ended June 2020 as total loan repayments received on commercial bank loans reduced to UGX.2,207.9 billion, compared to repayments of UGX.3,006.1 billion registered in June 2019 (Chart 16). The reduction in loan repayments may affect cash inflows and widen the liquidity gap for some banks going forward, and also have implications for banks' profitability as the effects of the pandemic on economic activity continue to unwind.

Chart 15: Quarterly gross extensions and interest recapitalised on commercial bank loans (UGX. billion)[9]

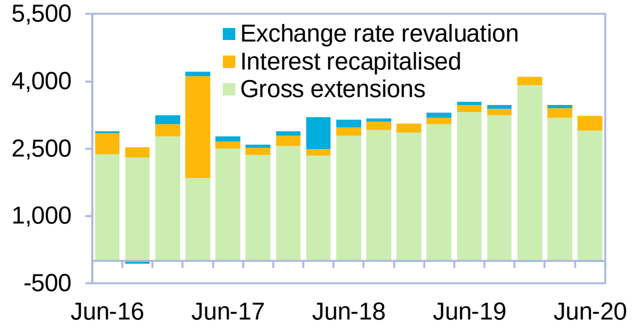
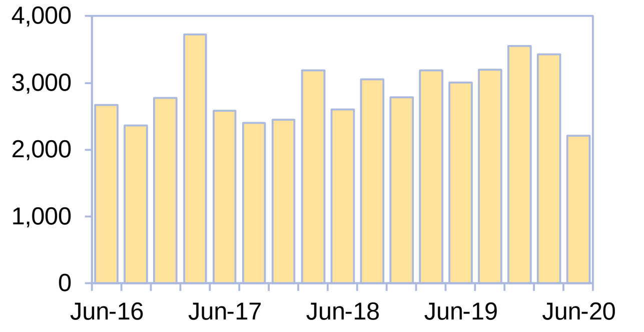


Chart 16: Quarterly loan repayments received by commercial banks (UGX. billion)



Source: Bank of Uganda

On aggregate, commercial bank lending to most sectors reduced, an indicator of banks' effort to diversify away from risky sectors adversely affected by COVID-19 and minimise credit losses. As result, loans to sectors hardest hit by the pandemic – manufacturing and trade and commerce – slowed down. And this too was the case for the transport sector. Credit to manufacturing reduced by 1.9 percent year-on-year by June 2020, compared to the 20.5 percent increase registered over the prior year ended June 2019. Similarly, credit growth to trade and commerce slowed down from 10.7 percent to 0.7 percent over the same period ending June 2020. On the contrary, the agriculture sector and the community and social services sector registered a rise in credit of 12.2 percent and 178.2 percent respectively (Chart 17).

Economic downturns tend to be correlated with downward pressure on real estate prices, with pass-through effects on loan collateral values and bank loan portfolio performance. Over the period to June 2020, credit to the construction and real estate sector accounted for 20.6 percent of banks' lending. In the same period, credit to the construction and real estate sector increased by UGX.3.2 trillion or 16.7 percent, compared to 11.0 percent registered over the year ended June 2019. It should be noted that the Residential Property Price Index (RPPI)[10] for property prices in the Greater Kampala Metropolitan Area decreased by 2.9 percent over the quarter ended June 2020. This is an important observation considering that bulk of credit in the banking sector is secured by real estate. A prolonged dislocation of real estate prices due to the impact of COVID-19 would increase banks' expected credit losses. As a mitigant to the actualization of this risk, BOU set a limit of 85 percent on the LTV ratio for residential mortgages and land purchases effective May 2020. The result has been an alleviation of the impact of falling property prices on the valuation of collateral held by banking institutions. In addition, the aggregate LTV ratio on foreign currency loans for land purchase has remained below 70 percent, a prudential limit set in March 2014; and notably the ratio of these foreign currency loans to total loans for land purchase reduced to 9.6 percent as at end-June 2020, from 43.0 percent registered as at the end of April 2014. Chart 18 shows a breakdown of loans to the building, construction and real estate sector.

---

[9] In the quarter to March 2017, one bank registered interest recapitalized amounting to UGX.2,095.0 billion.

[10] Uganda Bureau of Statistics, Residential Property Price Index (RPPI) Q4 2019/20 Press Release; Website: https://www.ubos.org/wp-content/uploads/publications/07_20204th_Quarter_2019-20_Report.pdf

Chart 17: Distribution of commercial bank loans by sector (UGX. billion)

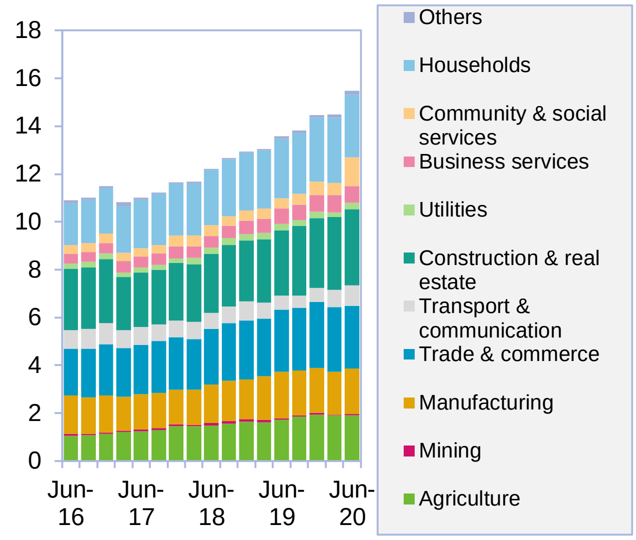
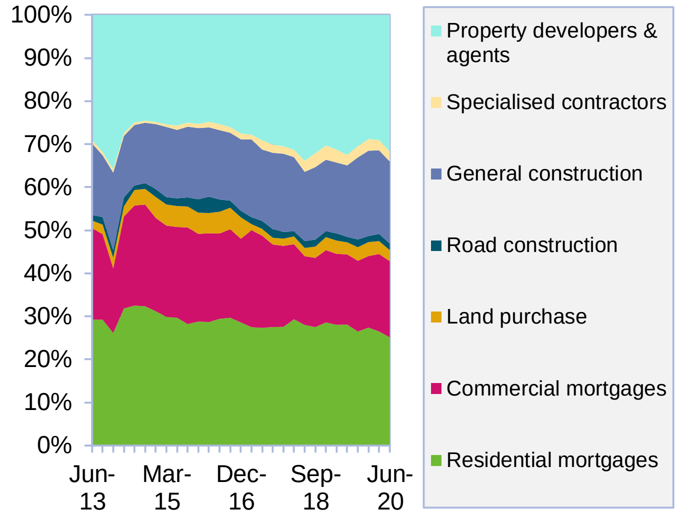


Chart 18: Credit to the building, construction and real estate sector, by percentage share (percent)



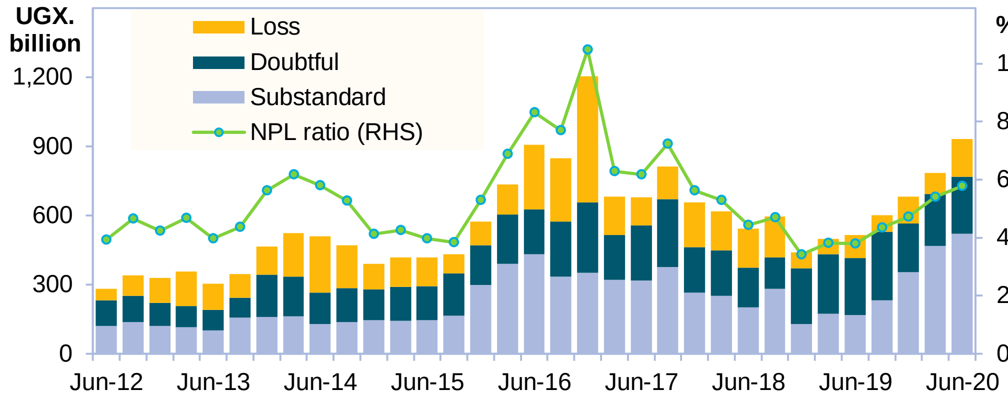
Source: *Bank of Uganda*

2.2. Evolution of credit risk

Bank's non-performing loans have risen during the down turn. The ratio of non-performing loans to total loans (NPL ratio) that was on an upward trend prior to the COVID-19 pandemic, worsened as the pandemic intensified through the year to June 2020. The NPL ratios for credit institutions and MDIs rose to 7.6 percent and 10.8 percent respectively, while the NPL ratio for commercial banks rose from 3.8 percent to 5.8 percent. Specifically for commercial banks, the volume of NPLs rose by 80.9 percent or UGX.416.7 billion. Of this increment, UGX.148.0 billion was accumulated in the quarter to June 2020. The deterioration in commercial bank loans was largely driven by an increase in NPLs in the real estate, trade and commerce, utilities, and household sectors by UGX.126.3 billion, UGX.150.3 billion, UGX.57.3 billion and UGX.64.7 billion respectively during the year under review. A decomposition of the aggregate NPLs shows that the substandard category drove the observed deterioration in commercial banks' NPLs. For the loans classified as doubtful and loss, aggregate NPLs remained largely unchanged partly due to the implementation of BOU's credit relief program that delayed their progression into subsequent categories (Chart 19).

Changes to accounting standards in recent years, particularly the introduction of the International Financial Reporting Standard (IFRS) 9, means that banks are required to take a more forward-looking approach to provisioning for expected credit losses. Accordingly, the slowdown in economic activity during the pandemic and uncertainty regarding the outlook has required that banks model potential credit impairments and prudently and proactively set aside more provisions for potential losses. The increase in NPLs and related provisions could have been higher but were moderated by the credit relief measures instituted by BOU in April 2020. BOU worked with the banking industry to implement a loan repayment deferral scheme under which borrowers affected by the pandemic can apply to defer loan repayments, extend the loan tenor with lower instalments or reduce the interest rate on the loan during the year to March 31st 2021. The Central Bank provided guidance to banks on how to apply the credit relief, provisioning regulations, and the credit reference bureau (CRB) framework in these cases. The scheme, whose performance as at June 2020 is illustrated in **BOX A,** also ensured that, in the short term at least, banks do not face automatic increases in capital requirements which are normally applied to restructured loans, thus enabling banks to preserve capital.

Chart 19: Classification of commercial banks' NPLs



Source: *Bank of Uganda*

Going forward, banks' performance will be affected by the trend of NPLs which are expected to increase further during the next year. Many firms whose business models remain disrupted by COVID-19, and households who face prolonged layoffs and shocks to incomes, will continue to struggle to make their loan repayments. There is a risk that a large volume of NPLs will begin to materialise after the initial credit relief offered to these borrowers expires.

As the initial loan repayment holidays end, banks are expected to take a case-by-case approach in working with distressed borrowers to assess their short and medium term prospects, and grant further extensions of credit relief where necessary. In the event that the decline in a borrowers' income is anticipated as temporary or transitory, it is in both banks' and borrowers' interests to agree on revised payment terms until the customers are in better positions to service their debt. On the other side of the coin, banks must appropriately and prudently provision for the performance of the rescheduled loans especially if the economic downturn is deeper or more prolonged. This prudent provisioning is to ensure the adequate coverage of loans to borrowers whose distressed financial condition is likely to be permanent and have limited or no prospects of full repayment being achieved in the short to medium term.

The Central Bank plans to undertake a review by end-2020 of the credit relief measures that were issued in April 2020, coupled with a stress testing exercise to assess the banking system's resilience to a more prolonged and severe economic downturn, which will guide additional measures regarding credit relief for distressed borrowers aimed at supporting economic recovery.

BOX A: Uptake of credit relief during the COVID-19 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.

- The stock of loans under credit relief as at end-June 2020 was UGX.4.9 trillion, equivalent to 31.2 percent of total loans by all banking institutions.

- The total amount of loans that was restructured since April 2020 was UGX.5.9 trillion. However, the monthly volumes have reduced gradually from UGX.2.3 trillion in April 2020 to UGX.491.0 billion in July 2020.

Table 6: Summary of credit facilities restructured by banking institutions in Uganda as at end-June 2020

	Stock of loans restructured (UGX. billion)	Stock of total loans to sector (UGX. billion)	Share of restructured loans to total loans per sector (percent)
Construction & real estate	1,326.6	3,152.9	41.6
Trade & commerce	1,316.1	2,603.1	50.5
Agriculture	652.9	1,876.6	33.9
Manufacturing	580.3	1,929.7	30.5
Community & social services	328.3	1,279.7	27.5
Business services	253.1	695.4	36.1
Households	244.2	2,693.6	9.3
Transport & communication	194.2	792.6	22.4
Mining & quarrying	8.3	41.0	5.4
Utilities	2.6	293.8	1.0
Other activities	-	136.3	-
Total	**4,906.6**	**15,489.0**	**31.7**

Source: Bank of Uganda

- The acceptance rate for applications for credit relief was high at 98.3 percent in the period April 2020 – July 2020 as total number of applications approved was 893,018 out of 895,241 applications 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.

- However, institutions have faced several challenges in effectively providing credit relief to borrowers, including limited access to customers due to the pandemic containment measures, misconceptions by borrowers about the eligibility and terms of restructured loans, as well as challenges in adhering to the IFRS 9 reporting requirements for computing expected credit losses. 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.

3. Operational risk

The pandemic 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. During the quarter ending June 2020, over half of the financial institutions' branches were closed and/or had shorter operating hours. While non-bank functions have largely been able to operate as normal and most bank staff have adapted to working from home, there is a concern that the necessary steps to close down banks' locations and branches whenever a COVID-19 infection occurs, impact access to financial services and require banks to implement costly contingency plans. Secondly, the pandemic has led to greater reliance on cashless or digital payment channels to complete transactions, in addition to a greater proportion of their staff working remotely. These developments have heightened the likelihood of disruptions related to information technology (IT) and cybersecurity incidents within the sector. The banking system has not been affected by a major cyber risk incident to date, however banks must ensure continuous vigilance and strengthen their resilience to ensure that this remains the case.

In order to address the aforementioned operational risks, BOU directed all the 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, which could then be passed on the consumers in the form of higher access costs of financial services over the short- to medium-term.

4. Banking sector profitability

On aggregate, banks remained profitable and the higher reserves boosted capital buffers. However, earnings started to decline in the six months to June 2020. Commercial banks' net after-tax-profit (NPAT) increased from UGX.775.1 billion earned during the year ended June 2019 to UGX.862.2 billion for the year ended June 2020. The increase was mainly on account of an increase in interest income of 12.3 percent, coupled with a reduced growth in personnel expenses of 7.0 percent down from 8.7 percent in the previous year, as remote working and staff layoffs increased. On the contrary, credit institutions' net earnings reduced by 73.8 percent, from UGX.13.4 billion to UGX.3.5 billion, while the MDI sub-sector registered aggregate losses of UGX.4.8 billion in the year to June 2020, largely due to the pandemic effect among the micro lending segments of the population that are served by these institutions. Consequently, the aggregate average return on assets (ROA) reduced to 2.6 percent, 0.6 percent and -1.4 percent for commercial banks, credit institutions and MDIs respectively, between June 2019 and June 2020 (Table 8).

Chart 20: Decomposition of commercial banks' income and expenses (annualised)

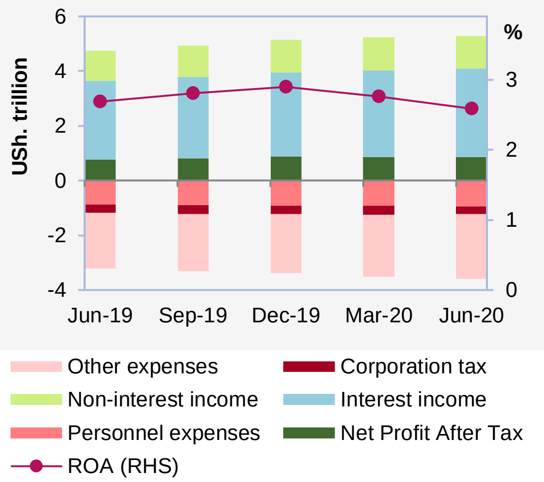


Table 7: Peer group analysis of commercial banks' profitability

Year to:	Bank category	NPAT (UGX. billion)	ROA (%)	Cost of deposits (%)	Cost to income (%)
Jun-19	Industry	775.1	2.7	2.3	72.9
	Large	609.4	3.5	1.9	67.1
	Medium	193.2	2.0	2.8	77.3
	Small	-27.5	-0.8	3.2	102.2
Jun-20	Industry	862.2	2.6	2.5	74.3
	Large	675.8	3.3	1.9	68.2
	Medium	185.9	1.8	3.3	80.4
	Small	0.5	0.03	4.4	98.5

Source: *Bank of Uganda*

There are two main risks to bank profitability arising from the pandemic. The costs related to business continuity planning and digitisation of services have started to push up operating costs. All banking institutions registered rises in their cost-to-income ratios. For commercial banks, the ratio increased from 72.9 percent in the year to June 2019 to 74.3 percent in the same period to June 2020, the highest level recorded in the last three years. Secondly, if the downturn in economic activity is deeper than previously anticipated, loan loss provisions are likely to rise further. The loan loss provisions expensed by the sub-sector amounted to UGX.300.1 billion, of which UGX.116.7 billion was in the quarter to June 2020.

Table 8: Average return on assets and cost ratios for banking institutions (percent, annualised)

Indicator	Institution type	June 2016	June 2017	June 2018	June 2019	June 2020
Return on assets	Commercial banks	2.2	1.7	2.8	2.7	2.6
	Credit institutions	0.3	0.1	2.2	2.0	0.6
	MDIs	1.8	3.1	3.1	3.5	-1.4
Cost to income	Commercial banks	78.4	81.6	72.8	72.9	74.3
	Credit institutions	101.6	99.4	91.9	90.9	104.3

Source: Bank of Uganda

Chart 21: Total assets of the banking sector

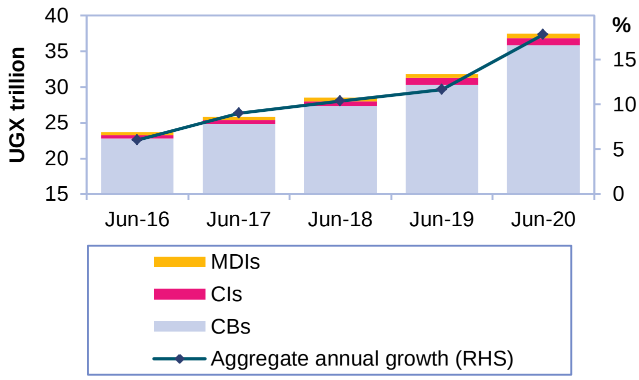
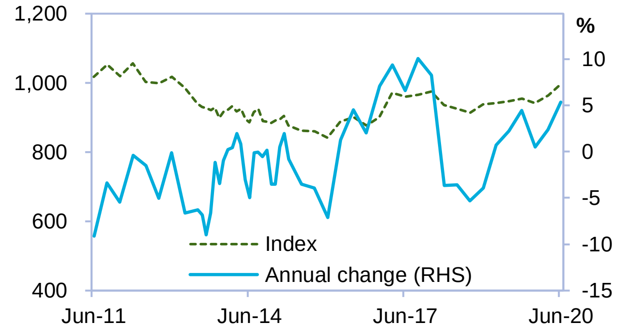


Chart 22: Herfindhal-Hirschman index of commercial banks' assets



Source: *Bank of Uganda*

A notable development in regard to market efficiency is the high concentration in the banking industry, with commercial banks accounting for 95.6 percent of the banking sector's total assets as at end-June 2020. This is a clear indicator of the banks' dominance therein. Credit institutions and MDIs constituted 2.6 percent and 1.8 percent of total assets, respectively. In the commercial banking sub-sector, the domestic systemically important banks (DSIBs) for the year 2020[11] – Absa Bank, Centenary Rural Development Bank, Stanbic Bank, and Standard Chartered Bank – increased their share of the sub-sector's total assets from 50.8 percent to 52.6 percent between June 2019 and June 2020. In addition, a peer group analysis[12] of the sub-sector shows that the five largest banks with 62.2 percent of total industry assets, accounted for 78.4 percent of the sub-sector's profits. The Herfindhal-Hirschman index (HHI) of commercial banks' assets also exhibited increased concentration in the sub-sector as it rose by 5.4 percent during this period, continuing an upward trend that

[11] In Bank of Uganda's framework for identifying domestic systemically important banks (DSIBs), the process of identification is carried out once a year in December.

[12] The segmentation of commercial banks is based on nominal asset size. The groups are defined as follows: assets greater than or equal to UGX.1.0 trillion for large banks, assets greater than or equal to UGX.500 billion but less than UGX.1.0 trillion for medium-sized banks, and assets less than UGX.500 billion for small banks.

began in December 2018 (Chart 22). The central bank shall continue to monitor this trend and take appropriate measures to enhance market efficiency in order to enhance competition in the banking system.

5. Bank capital buffers

On aggregate, banks held strong capital buffers, including all DSIBs, which considerably enhanced their resilience to shocks from the pandemic. The core capital adequacy ratios 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 requirement of 15 percent. The increase in capital ratios was mainly reflective of the slowdown in loan growth and higher retained annual earnings. The industry's strong capital base was further augmented by retained reserves following BOU's decision to waive limitations on the restructuring of loans by banking institutions and to defer dividend payments and bonuses in March 2020.

However, it is expected that subdued credit could put downward pressure on banks' interest income, while rising provisions will erode profitability for banking institutions. Nonetheless, stress tests conducted on the banking sector to determine the adequacy of capital buffers showed that on aggregate, most banks had adequate capital buffers to withstand a broad range of adverse shocks while retaining adequate capital to support the economic recovery. In addition, in order to ensure that banks continue to build up sufficient capital buffers as the pandemic evolves, the central bank has taken the following measures;

a) *The Financial Institutions (Capital Buffers and Leverage Ratio) Regulations,* which are expected to be gazetted by the end of 2020, will require that banks comply with Basel III capital buffers in order to ensure that they can absorb losses without breaching the minimum ongoing capital requirements.

b) BOU required all banks that wish to pay dividends to undertake internal capital adequacy assessments (ICAAP), in order to demonstrate that they have sufficient capital buffers to withstand the potential drawn-out impact of the pandemic on their asset quality and profitability. This exercise is expected to further enhance capital planning and bank resilience.

6. Conclusion

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. Nonetheless, banks have continued to support businesses and households whose income was affected by the pandemic, underpinned by BOU policy measures. Despite some institution-specific challenges, overall, banks are well positioned with sufficient liquidity and capital buffers, to play a key role in absorbing the shock and supporting recovery.

C. Developments in Other Financial Institutions and Payment Systems

This section analyses the performance of payment systems, insurance sector, pension sector and capital markets during the pandemic period. Supported by early the measures from the supervisory agencies, institutions in these sectors have taken action to help absorb the pandemic shock and support affected households and businesses. Nevertheless, operating conditions remain challenging.

1. Performance of financial market infrastructures

Financial market infrastructures (FMIs) are key components of the financial system responsible for providing clearing, settlement and recording of monetary and other financial transactions. FMIs are vital to the smooth functioning of the financial system and maintaining financial stability as they facilitate efficient payment for goods and services and risk management. Therefore, their failure could lead to systemic instability. Given their central role, FMIs require sound design and high standards of operational and financial resilience. This section describes the performance of Uganda's FMIs in the year to June 2020 with highlights of the key developments that have occurred as a direct effect of the COVID-19 pandemic.

Uganda's key FMIs at the end of June 2020 included: the Uganda National Interbank Settlement System (UNISS) – Uganda's real time gross settlement system; the Automated Clearing House (ACH) – for cheques, direct debit and credit transfers; and an electronic Central Securities Depository (CSD) – for government securities. Others FMIs include systems supplied by private sector players such as mobile money services. Overall, FMIs remain resilient to disruption in the face of COVID-19.

1.1. Clearing and settlement systems

Clearing and settlement systems have remained robust during the pandemic with no indication of a significant increase in the risk of disruption. Clearing and settlement systems registered notable growth in value of transactions in the year to June 2020. The value of UNISS transactions represented 76.0 percent of the total value of all payments systems. These also rose by 4.1 percent to UGX.367.1 trillion in the year to June 2020. The number of transactions and values of electronic funds transfers (EFTs) rose by 4.9 percent and 13.6 percent respectively in the year to June 2020. The increase in the value of EFTs (UGX.51.0 billion) was notable in the quarter ending June 2020, which was the time when the country-wide lockdown to curtail the spread of COVID-19 was instituted.

Table 9: Summary of activity in Uganda's clearing and settlement systems

Year ended	Jun-17	Jun-18	Jun-19	Jun-20
UNISS				
Number (million)	0.8	0.8	0.7	0.9
Change (%)	8.5	6.5	-9.4	23.4
Value (UGX. trillion)	275.4	315.0	352.6	367.1
Change (%)	17.7	14.4	11.9	4.1
EFT's				
Number (million)	8.6	9.4	9.9	10.4
Change (%)	21.1	9.3	5.0	4.9
Value (UGX. trillion)	19.1	23.3	27.9	31.7

Year ended	Jun-17	Jun-18	Jun-19	Jun-20
Change (%)	25.1	21.7	19.9	13.6
Cheques				
Number (million)	1.2	1.1	1.5	1.2
Change (%)	8.6	-11.0	36.7	-16.1
Value (UGX. trillion)	6.1	5.8	8.0	6.9
Change (%)	8.3	-4.1	37.4	-13.8

Source: Bank of Uganda

1.2. Mobile money payments

Mobile money systems, which provide a vital financial payments lifeline for a significant share of households and small business across the country, also operated normally with minimal disruption. The year to June 2020 registered significant growth in mobile money transactions. The value of transactions grew by 19.3 percent to UGX.79.8 trillion, of which UGX.40.7 trillion was in the second half to June 2020. In addition, the escrow account balances increased by 51.8 percent from UGX.632.7 billion in June 2019 to UGX.960.2 billion in June 2020, with an 18.0 percent increase in the quarter ending June 2020. 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 the removal of limits on frequency of transactions between March 2020 and June 2020.

Going forward, as the government continues to encourage the use of non-cash payments in face of COVID-19 pandemic to limit infections, the use of mobile money services is bound to increase and consequently contribute to financial sector deepening.

Table 10: Summary of annual mobile money payments activity

Year ended	Jun-17	Jun-18	Jun-19	Jun-20
Mobile money				
Number (billion)	1.1	1.3	2.5	3.1
Change (%)	37.3	21.1	85.3	25.4
Value (UGX. trillion)	52.8	73.1	66.9	79.8
Change (%)	41.0	38.5	-8.5	19.3
Escrow account balances				
Value (UGX. billion)	323.2	496.0	632.7	960.2
Change (%)	3.1	53.5	27.6	51.8

Source: Bank of Uganda

1.3. Electronic payment systems

The longer-term impact of COVID-19 on FMIs is likely to be a significant rise in the use of electronic payment systems and digital banking services. The use of digital payment products picked up further in the year to June 2020, partly driven by actions taken by financial institutions to promote the use of cashless transactions as a measure to reduce the risk of COVID-19 transmission. Funds transferred through credit cards rose by 19.7 percent, and the number and value of point-of-sale (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 11: Summary of activity in Uganda's electronic payment systems

PAYMENT SYSTEMS		Jun-19	Jun-20	Change (%)
Debit cards	Active number of cards (millions)	2.4	2.4	-0.6
	Volume of payments (millions)	3.4	13.1	281.4
	Value of payments (UGX. billion)	670.3	3,188.2	375.7
Credit cards	Active number of cards	9,247.0	10,004.0	8.2
	Volume of payments	164,091	194,680	18.6
	Value of payments (UGX. billion)	56.4	67.5	19.7
Points-of-sale	Volume (million)	2.0	2.5	27.5
	Value (UGX. billion)	485.4	555.8	14.5
Internet banking	Active number of users	559,391	764,533	36.7
	Volume of fund transfers (million)	2.2	3.6	61.1
	Value of fund transfers (UGX. trillion)	21.4	32.7	61.1
Mobile banking	Active number of users (million)	0.7	1.1	46.9
	Volume fund transfers (million)	23.1	32.5	40.4
	Value of fund transfers (UGX. trillion)	1.1	2.83	163.6

Source: Bank of Uganda

1.4. Risks related to digital payment systems

Systemically important FMIs operated without significant disruptions during the year to June 2020. However, the increased use of digital platforms invariably heightens risks associated with their use, especially those related to cybersecurity over the short term. In this regard, BOU continues to encourage institutions to innovate, promote and leverage electronic banking and payment channels in a prudent manner that minimises the occurrence of these risks, but at the same time promotes financial sector 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. BOU will continue to monitor developments with respect to these various FMIs innovations.

2. Developments in other financial corporations and response to COVID-19 by financial sector regulatory agencies

Financial sector regulatory agencies in Uganda cooperate under a memorandum of understanding that established the Financial Sector Stability Forum (FSSF). Since the COVID-19 outbreak began in early 2020, these agencies continued to conduct regular monitoring on the impact of the pandemic for their respective regulated institutions and implement suitable measures aimed at stabilising markets and mitigating the negative impact of the pandemic.

2.1. Capital markets

2.1.1. Assets under management

During the year to June 2020, the total assets under management (AUM) by fund managers increased by 18 percent from UGX.2.9 trillion to UGX.3.5 trillion; the AUM continued to grow amidst the COVID-19 pandemic.

Table 12: Assets under management by domestic fund managers (UGX. billion)

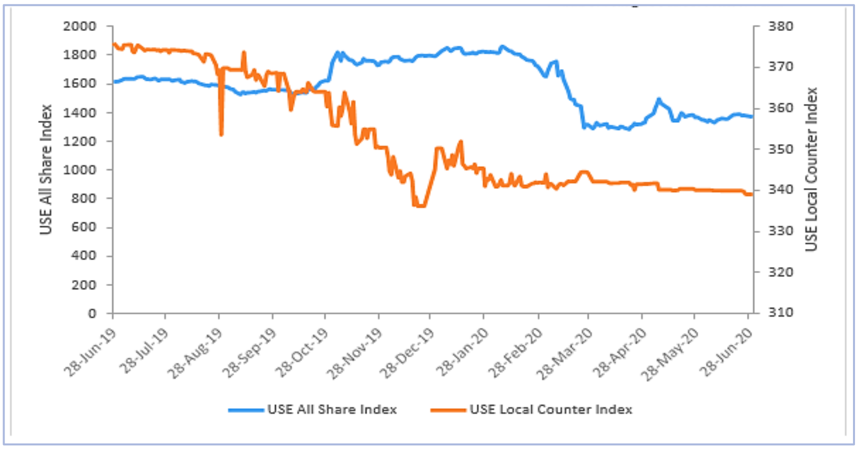
FUND MANAGER	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Annual change (%)
STANLIB Uganda Limited	394	410	247	-	-	NA
Sanlam	1,325	1,300	1,350	1,429	1,551	17
Insurance Company of East Africa	114	123	123	134	163	42
UAP Financial Services - Old Mutual	247	264	273	346	363	47
GenAfrica	730	812	847	941	1,017	39
Britam	154	211	225	404	410	167
Total	2,964	3,119	3,064	3,253	3,505	18

Source: Capital Markets Authority

2.1.2. Activity on the Uganda Securities Exchange

Overall, the Ugandan equity markets realised a total market turnover of UGX.116 billion for the year ended June 2020, an increase of 153.0 percent from that recorded for the same period to June 2019. However, from December 2019, there was a gradual decline in total market turnover. As a result, the trading volume and market turnover of the USE declined by 97 percent and 98 percent respectively during the second half of the financial year 2019/20 and the total equities market capitalization declined by 32 percent, from UGX.25 trillion in January 2020 to UGX.19 trillion in June 2020. Nonetheless, the stock brokers remained compliant with the net capital requirements during this period, with only one broker reporting a deficient net capital position but subsequently recapitalized. Fund managers and unit trust managers were generally compliant with the shareholder and liquid resources requirements during the period. Only two fund managers defaulted but were subsequently restored by end-June 2020.

Chart 23: USE ALSI and LCI Levels from June 2019 to June 2020



Source: Uganda Securities Exchange

Table 13: Uganda Securities Exchange market capitalisation (UGX. billion)

Counter	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Annual change (percent)
Total domestic market capitalisation	4,908.8	4,708.2	4,408.5	4,308.9	4,226.6	-14.0
Total market capitalisation	22,657.0	21,784.0	24,930.4	18,214. 9	19,089.5	-16.0

Source: Capital Markets Authority

The reduction in overall activity in the market was attributed to among other things, muted participation from both domestic investors and off-shore investors (who account for over 70 percent of the turnover on the Uganda Securities Exchange (USE)) due to the economic uncertainty generated by the COVID-19 pandemic, and the fall in share prices on the cross-listed and local listed counters with the exception of British American Tobacco Uganda Limited whose share price remained unchanged.

2.1.3. Policy responses and measures

- The Capital Markets Authority (CMA), which provides regulatory oversight over the sector, focused on ensuring continuity of critical operations of the market, monitoring market activity to ensure investor protection, and providing appropriate regulatory guidance to intermediaries.
- It exercised flexibility in the supervisory mandate in areas of licensing renewals and applications by promoting electronic submission, as well as flexibility in timelines of submission of information.
- The Authority suspended onsite inspections temporarily, and guidance was issued to listed companies on annual general meetings.
- The Authority proposed guidelines for mutual funds that included waiving license fees for some unlicensed entities.
- CMA also encouraged business owners whose operations had been affected by the COVID-19 pandemic to consider investing in risk-free and safe assets like government securities and cash investments as these give interest and yet are safe.

2.2. The retirement benefits sector

At this stage, it is not clear what significant impact, if any, COVID-19 will have on retirement benefits, which tend to have a long term horizon. Nevertheless, indicators show that the pandemic has had short term adverse effects on the operations of retirement savings schemes, providers, regulators and supervisors, and may lower future retirement incomes.

As at end-June 2020, the retirement benefits sector comprised 66 licensed retirement benefits schemes with a total of UGX.15.2 trillion in assets under management which rose by 16.8 percent over the year to June 2020. Asset allocation for retirement benefits schemes continues to depict a heavy bias towards fixed income securities with government securities, accounting for 75.9 percent of total investments at the end of the review period. Investments in quoted securities were the second largest, accounting for 12.4 percent, of which 70 percent were in equities held in the Nairobi Stock Exchange compared to 22.6 percent held in the USE.

The pandemic and its knock on effect on the financial returns from the asset allocation of the funds, affected the median return on schemes for quoted equities, fixed income and money market which was -8.4 percent, 14.3 percent and 10.9 percent as at June 2020, compared to -11.8 percent, 15.6 percent and 9.8 percent over a similar period in 2019. In terms of portfolio concentration, the financial and technology sectors continued to dominate, accounting for 49.1 percent and 30.6 percent respectively as at end-June 2020. However, due to the impact of COVID-19, there were major declines in eight sectors except the utilities and energy sectors which increased by 20.4 percent and 2.8 percent respectively.

Table 14: Investment portfolio of the retirement benefits sector

	June 2019	June 2020
Total investments (UGX billions)	**13,015**	**15,207**
Asset class by percentage share of total investments (%)		
Cash on demand	0.5	0.4
Fixed deposit	1.9	2.2
Other fixed income*	0.8	0.6
Government securities	74.6	75.9
Quoted equities	13.5	12.4
Unquoted equities	2.6	2.4
Immovable property	6.1	6.1
Other investments	0.1	0.08

**"Other fixed income" asset class represents commercial paper, corporate bonds, ABS, and CIS. "Other investments" represent guaranteed funds and other approved assets structures.*

Source: Uganda Retirement Benefits Regulatory Authority

Overall, COVID-19 is expected to continue affecting the retirement benefits sector, particularly leading to a decline in the average growth rate of pension funds' assets from depressed financial market activity and a reduction in remittances of contributions if contributors' wages are affected by lost income or financial distress of employers. In the medium term, scheme administrators could witness unscheduled or unplanned benefits pay-outs coupled with reduced or suspended monthly contributions.

2.2.1. Policy responses and measures

- In response to the aforementioned risks, the Uganda Retirement Benefits Authority (URBRA) extended the deadline for the submission of audited financial statements for year ended December 2019 by schemes to 30th May 2020.
- Fund managers and scheme administrators were required to enhance monitoring of emerging risks and minimise likely losses, for instance through; re-organising scheme investment policy statements, contribution reconciliation, benefits payment and data.
- The Authority also offered guidance on scheduling and conducting virtual scheme annual general meetings.

Going forward, URBRA will continue to provide guidance to schemes on a case-by-case basis on contributions of deferral/ amnesty, contributions of temporary waivers, contributions cancellation, and reduction in contribution rates.

2.3. Non-deposit-taking microfinance institutions

Analysis by Uganda Microfinance Regulatory Authority (UMRA) indicated that the virus-containment measures that were put in place to prevent the spread of coronavirus affected the activities of low-income households and thus their ability to generate savings and service their loan obligations. The saving behaviour in many SACCOS reduced greatly, and the repayment rates of many borrowers dropped as they struggled to make ends meet due to income shocks in the period to June 2020. As a result, the implications for non-deposit-taking microfinance institutions (MFIs) were threefold; first, the liquidity buffers of many MFIs[13] were greatly affected since they depend on loan repayments for further lending. In the six months to June 2020, MFIs closed over 30 branch networks due to high operating costs and diminished earnings. Between March 2020 and June 2020, money lenders reported a reduction in the growth of number of borrowers from 52.0 percent to 48.0 percent due to less supply of credit as the credit providers continued to seek for recapitalization. In the same period, MFIs showed a slowdown in the number of borrowers from 50.9 percent to 49.1 percent due to emphasis by institutions on delinquency management other than credit supply.

2.3.1. Policy responses and measures

In response to the challenges presented by the pandemic, UMRA implemented the following measures by June 2020;

- UMRA is working to source liquidity support for microfinance institutions that may come under liquidity stress due to the heightened credit risk from loan defaults.

- UMRA issued guidelines on credit management and restructuring during the COVID-19 pandemic. Institutions were advised to consider offering payment moratoria for loans that were disbursed before the pandemic, and borrowers were encouraged to request for credit relief where eligible. UMRA clarified that any fees chargeable due to credit restructuring during the pandemic should be reasonable and justifiable by the institution, and the Authority further directed institutions to continue adhering to the consumer protection guidelines in place.

- The Authority also encouraged institutions to assess portfolio quality, financial and liquidity positions to avoid surprises in the aftermath of the pandemic.

- Licensees were encouraged to adopt digitalisation of services to survive in the pandemic and adjust to the new normal operating environment. UMRA also plans to build capacity through trainings for the licensees on how they can survive in the new normal operating environment.

2.4. The insurance sector

Insurers have an important role in the financial system through their spreading of households' and businesses' risks. The sector has experienced elevated profitability and as at the end of June 2020, remained well capitalised to withstand temporary market downturns or moderate increases in unexpected insurance claims. The majority of the insurance companies had capital adequacy ratios above the statutory level of 200 percent.

[13] SACCOs, non-deposit-taking microfinance institutions, and money lenders

Total assets grew by 9.4 percent growth in the year to June 2020 while total industry gross written premiums (GWP) increased by 7.8 percent from UGX.495.0 billion to UGX.534.5 billion during the same period. Particularly, non-life insurance GWP increased by 3.4 percent while life insurance GWP increased by 20.6 percent. In addition, health maintenance organisation (HMO) GWP increased by 3.9 percent from UGX.35.7 billion to UGX.37.1 billion while specialist micro insurer GWP amounted to UGX.207.8 million in June 2020.

COVID-19 has affected insurers in a number of ways. While direct impacts as a result of COVID-19 are likely to be modest, sector-specific exposure is likely to be significant. The slowdown in economic activity due to COVID-19 resulted in low disposable income and hence, minimal or no allocation to insurance premiums. Thus, the uptake of new policies dropped as many policyholders opted out of insurance by not renewing their policies. The government also rationalised its budget priorities and this affected infrastructure projects and donor-funded projects, all of which contribute greatly to the sector performance. The initial response to COVID-19 created major disruptions to the travel industry and affected premiums generated from travel insurance while claims on travel insurance could rise. At the same time, claims for credit insurance policies could rise as the economic downturn deepens.

2.4.1. Policy responses and measures

In response to the pandemic, the Insurance Regulatory Authority (IRA) played a dual role in ensuring that the sector players remained stable and capable of delivering on their commitments to their clients.

- The Authority provided guidance to insurance companies on measures to preserve their capital so that they remain solvent and operational as insurance services continued to be provided. As such, companies were directed not to distribute dividends without the approval of the Authority.

- The guidelines issued by the IRA allowed for relaxed claims payment conditions including, but not limited to, extension of grace periods and accepting instalments so as to minimise fraudulent activities. In particular, life insurers are to explain the implications of cancelling life policies with investment/savings component and allow the deferral of loan repayments for the financing facility.

- IRA also encouraged insurance players to invest in digital platforms and channels to allow for continuity of insurance operations. This followed the requirement for insurance providers to develop more flexible approaches to extending their products and services with minimal or no physical interaction with clients. Insurers were also advised to reconsider the processes, products and services they offer as well as the operating models to seize the new emerging opportunities while operating in the unprecedented times of COVID-19.

Going forward, IRA plans to undertake an information and communications technology audit and provide guidance on the minimum benchmarks for the industry which will be enforced. The Authority shall also examine the adequacy of the insurance companies' business continuity plans (BCPs) and provide necessary guidance.

D. Assessment of Systemic Risk and Outlook for Financial Stability

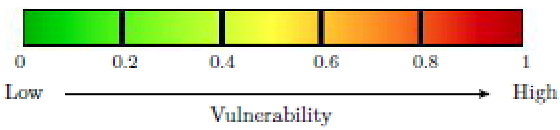
The COVID-19 pandemic has elevated systemic risks to financial stability. Nevertheless, the Ugandan banking sector has remained resilient in the face of the shock and has been supported by a range of measures from BOU.

1. Overview of systemic risks to the banking sector

Bank of Uganda's systemic risk dashboard, a composite tool for assessing key risks to the banking system, shows that overall systemic risk increased by 4.7 percent during the year to June 2020 to reflect the evolution of risks laid out in other parts of this Report (Figure 1). The main sources of enhanced systemic risk as summarised by the dashboard include the slowdown in economic activity, the deterioration in credit quality, mild funding pressures, and the gradual decline in the sector's competitiveness and efficiency.

Figure 1: Bank of Uganda systemic risk dashboard

Summary	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Quarterly change (%)	Annual change (%)
Overall risk						**9.3**	**4.7**
Macro risk						**29.2**	**13.3**
Credit risk						-16.3	-7.7
Credit growth						-5.3	-41.5
Credit concentration						-4.3	-8.8
Credit quality						-32.2	**19.4**
Liquidity risk						**9.7**	-29.1
Market liquidity						-16.4	-47.4
Funding liquidity						**30.7**	-8.0
Market risk						-16.3	**11.3**
Foreign exchange risk						-11.3	-17.2
Interest rate risk						**4.9**	**10.0**
Asset price risk						-41.2	**32.0**
Profitability & solvency						**3.0**	-5.3
Profitability						**11.6**	-1.1
Solvency						-20.9	-12.3
Structural risk						**23.3**	**38.0**
Contagion risk						**62.8**	**15.8**



Weaker economic activity will result in loan losses rising materially from current levels and therefore the banking system's resilience will be tested in the coming months. On an annual basis to June 2020, the banking system remained resilient, supported by actions taken by BOU to ease financial market stress and boost economic activity. However, in the quarter to June 2020, the resilience index, a weighted composite indicator that monitors risks endogenous to the banking sector[14], indicates that aggregate banking sector resilience declined, largely due to a rise in provisions for bad loans, the pick-up in NPLs and higher operating costs. Notwithstanding, banks remain well positioned to support the economic recovery and their loss-absorbing capacity improved with enhanced their capital and liquidity buffers, compared to the previous year to June 2019.

Chart 24: Changes in the banking sector resilience index (percent)

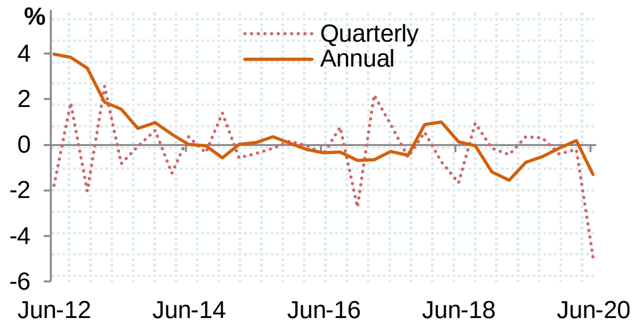
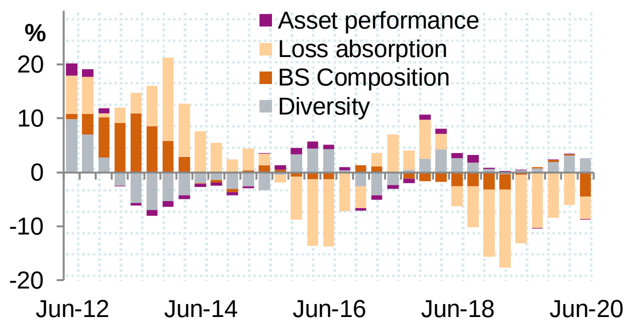


Chart 25: Decomposition of the changes in the banking sector resilience index (percent)



Source: Bank of Uganda

2. Solvency stress tests of the banking sector

In order to test banks' resilience to a significant worsening of the economic outlook, BOU carried out stress tests, particularly focusing on credit risk and solvency, which is the most pertinent risk during the pandemic. The exercise aimed covered a forecast period of one year up to June 2021[15] and the results of the exercise are provided in Chart 26 – Chart 29. There were three scenarios considered;

- ***The baseline scenario*** was based on BOU's macroeconomic forecasts whereby real GDP is estimated to grow at annual rate of 3.0 percent in in the year to June 2021[16]. In this event, annual credit growth would decline from 14.0 percent in June 2020 to 0.2 percent in the year to June 2021. The impact on banks' loan quality would be an increase in total bank NPLs of 25.3 percent to reach UGX.1.1 trillion, which would push the NPL ratio to 7.2 percent. The losses on total regulatory capital would amount to UGX.14.6 billion over the forecast period.

- ***The adverse scenario*** assumed that economic output deviates from the baseline GDP growth projection by a magnitude equivalent to one standard deviation. The result of the shock is a reduction in real GDP growth to 0.9 percent and a contraction in credit growth by 5.1 percent in the year to June 2021. The NPL ratio rises to 9.7 percent as total NPLs increase by 30.7 percent to UGX.1.2 trillion. The resulting losses on capital would be UGX.86.1 billion, and the core CAR increases to 24.1 percent due to the sharp decline in credit growth outstripping the reduction in capital.

---

[14] The index consists of macroprudential indicators grouped into four dimensions that are believed to adequately capture the resilience of Uganda's banking system: diversity, balance sheet composition (BS Composition), and loss absorbing capacity.

[15] It should be noted that the assessment of the impact of the various scenarios in this exercise does not account for the emergency credit and liquidity relief measures that have been put in place by Bank of Uganda.

[16] Monetary Policy Report, March 2020, Bank of Uganda

- In addition to the economic output scenarios, an ad hoc shock was calibrated to test banks' resilience to the deterioration of their loan portfolio subject to the credit relief measures. The scenario took into consideration the likelihood that borrowers who had received credit relief may still be distressed even after the expiry of the relief period and subsequently default. The shock assumed that 25.0 percent or UGX.334.2 billion of the loans which were restructured with a repayment holiday of up to three months would progress into NPLs classification. This scenario would result in NPLs increasing to UGX.1.2 trillion by September 2020; the NPL ratio would rise to 7.9 percent, and the aggregate core CAR reduces to 20.7 percent.

Chart 26: Annual real GDP growth (percent)

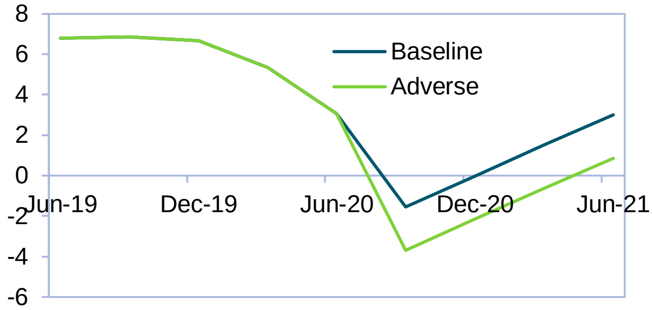


Chart 27: Annual bank credit growth (percent)

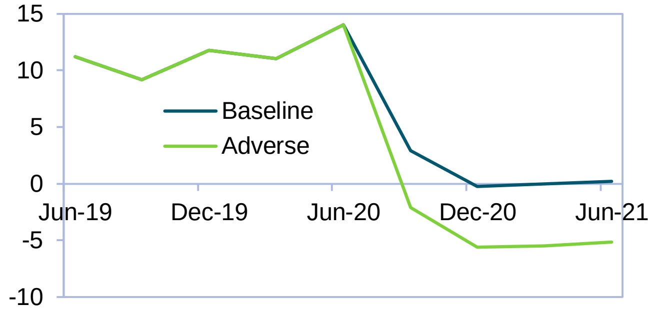


Chart 28: Resultant NPL ratio from macro scenarios (percent)

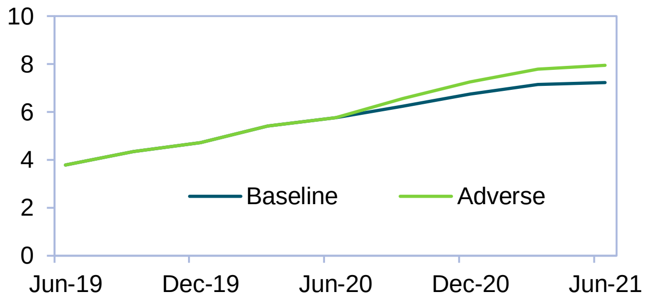
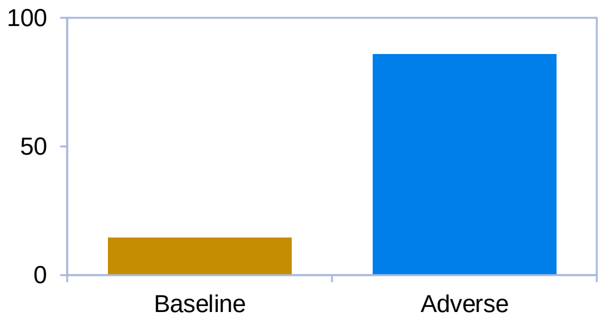


Chart 29: Total shortfall in capital due to potential shocks (UGX. billion)



Source: Bank of Uganda

Overall, the results showed that as at end-June 2020, under the range of projected economic circumstances, most banks, including all the DSIBs, were well capitalised to withstand any further deterioration in their loan books for at least one year to June 2021.

3. Outlook for financial stability

Since our last Report as at the end of June 2019, the outbreak of COVID-19 has reduced the near-term outlook for financial stability and there remains considerable uncertainty about the future trajectory of the pandemic. Moreover, financial sector performance tends to lag economic shocks and hence the full effect of COVID-19 on the financial sector is yet to fully emerge.

Consistent with this outturn, BOU has implemented several decisive measures since the outbreak of the pandemic, in order to support banks absorb the shock, alleviate shocks to financial stability and enable banks to keep lending, including;

- Exceptional permission to supervised financial institutions (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. This includes liquidity facilities for Tier 2 and Tier 3 institutions, which previously did not have access to BU standing facilities.

- A limit of 85 percent on the loan-to-value (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 UGX.436.3 billion (US$118.72 million).

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

The aforementioned measures have been effective in alleviating the impact of the pandemic on the performance of the banking system. Nevertheless, the outlook points to challenging conditions for the banking sector going forward and systemic risks are likely to remain elevated in the near term until economic recovery is stronger. At the same time, maintaining access to credit is crucial to ensure that households and businesses that are facing temporary losses of income are able to meet their financial obligations. BOU stands ready to take additional measures to safeguard financial sector stability as the pandemic evolves.

E. STATISTICAL APPENDICES

Appendix 1: Commercial banks' quarterly financial soundness indicators (percentage ratios)

	June 2018	Sept 2018	Dec 2018	Mar 2019	June 2019	Sept 2019	Dec 2019	Mar 2020	June 2020
Capital adequacy									
Regulatory capital to risk-weighted assets	21.8	21.6	21.6	22.3	22.1	21.4	21.8	21.9	22.7
Regulatory tier 1 capital to risk-weighted assets	19.7	19.8	19.8	20.4	19.6	19.6	20.1	20.3	21.1
Leverage ratio	11.1	11.4	11.1	11.5	11.1	11.0	10.7	11.8	11.6
Asset quality									
NPLs to total gross loans	4.4	4.7	3.4	3.8	3.8	4.4	4.9	5.4	6.0
NPLs to total deposits	2.8	3.1	2.3	2.6	2.5	2.8	3.1	3.3	3.7
Sectoral distribution of gross loans (%)									
Agriculture	12.2	12.4	12.7	12.5	12.6	13.4	13.5	13.1	12.4
Mining and quarrying	0.7	0.8	0.7	0.8	0.6	0.5	0.6	0.3	0.3
Manufacturing	13.2	13.2	12.9	13.8	14.3	13.5	12.8	12.3	12.3
Trade	19.2	19.1	18.9	18.5	19.1	18.9	19.2	18.7	16.8
Transport and comm.	5.4	5.4	6.2	5.1	4.4	3.7	3.9	5.0	5.6
Building and construction	20.1	20.3	19.8	20.3	20.1	21.1	20.2	20.9	20.6
Personal loans	18.9	18.8	18.7	18.7	18.3	18.5	18.4	18.9	17.0
Others	0.4	0.3	0.4	0.5	0.9	0.8	0.8	0.9	1.0
Large exposures to total capital	113.7	116.9	112.5	110.5	116.7	116.7	110.0	101.7	107.5
Earnings & profitability									
Return on assets	2.8	2.8	2.5	2.8	2.7	2.8	2.9	2.8	2.6
Return on equity	16.7	16.3	14.4	15.9	15.8	16.1	16.7	15.9	15.2
Net interest margin	11.5	11.3	11.1	11.0	11.2	11.2	11.3	11.2	10.9
Cost of deposits	2.5	2.4	2.3	2.4	2.3	2.5	2.5	2.6	2.5
Cost to income	72.8	72.6	73.9	72.1	72.9	72.2	72.0	73.2	74.3
Overhead to income	51.2	52.3	53.7	53.0	52.2	51.4	51.6	51.6	51.0
Liquidity									
Liquid assets to total deposits	46.6	43.9	45.5	44.1	45.5	50.3	48.6	48.8	49.4
Total loans to total deposits	63.4	66.7	66.0	66.7	64.7	64.2	63.2	61.5	60.9
Market sensitivity									
Foreign currency exposure to regulatory tier 1 capital	-5.2	-5.2	-7.5	-4.3	-3.6	2.4	4.7	6.5	6.9
Foreign currency loans to foreign currency deposits	62.9	67.8	63.0	68.3	61.8	62.8	60.1	56.6	62.7
Foreign currency assets to foreign currency liabilities	99.9	98.5	94.1	91.3	88.2	86.5	92.4	93.8	98.2

Source: Bank of Uganda

Appendix 2: Commercial banks' quarterly balance sheet (UGX. billion)

	June 2018	Sept 2018	Dec 2018	Mar 2019	June 2019	Sept 2019	Dec 2019	Mar 2020	June 2020
ASSETS (UGX. billion)									
Cash & cash assets	902.8	944.0	1,293.4	884.3	949.5	997.4	1,318.3	11,710.8	1,240.3
Balances with BOU	2,880.1	2,920.5	2,784.0	2,101.0	2,771.6	2,663.4	3,331.4	2,969.6	3,948.8
Due from financial institutions	3,354.4	3,064.7	2,958.4	2,794.4	2,905.3	2,747.4	3,203.9	3,997.3	3,829.9
Government securities	5,768.7	5,538.6	6,031.9	6,774.3	6,615.2	6,566.1	7,214.9	7,366.8	7,705.3
Total gross loans & advances	12,216.4	12,662.2	12,935.7	13,051.9	13,583.4	13,827.2	14,459.5	14,490.3	15,503.8
LESS: Provisions	-325.0	-355.5	-273.8	-274.0	-298.0	-333.7	-347.9	-345.1	-433.7
Net loans & advances	11,891.5	12,306.7	12,661.9	12,777.9	13,285.4	13,493.5	14,111.6	14,145.1	15,070.1
Net fixed assets	852.0	846.2	854.4	974.3	989.3	1,110.1	1,160.9	1193.1	1187.9
Other assets	1,723.1	1,643.5	1,536.9	2,320.1	2,760.0	3,396.0	2,487.1	2,742.4	2,843.2
TOTAL ASSETS	**27,372.6**	**27,264.3**	**28,120.8**	**28,626.4**	**30,276.3**	**30,973.8**	**32,828.2**	**33,585.2**	**35,825.4**
LIABILITIES (UGX. billion)									
Deposits	19,282.7	18,980.1	19,595.7	19,555.8	20,988.8	21,550.9	22,870.6	23,576.8	25,471.3
Due to financial institutions	565.8	582.2	574.1	714.2	553.6	553.8	683.9	896.4	725.7
Administered funds	895.9	983.7	1,023.5	1,093.5	1,038.0	1,127.1	941.4	918.9	1,017.7
Other liabilities	1,982.5	1,895.8	1,990.5	2,233.6	2,545.7	2,408.4	2,712.3	2,405.5	2,558.1
TOTAL LIABILITIES	**22,726.9**	**22,441.7**	**23,183.8**	**23,597.0**	**25,126.1**	**25,640.2**	**27,208.1**	**27,797.6**	**29,772.7**
CAPITAL (UGX. billion)									
Paid-up capital	1,332.8	1,332.8	1,332.8	1,335.8	1,358.7	1,363.5	1,400.4	1,434.8	1,425.4
Share premium	347.8	347.8	347.8	347.8	1,177.7	1,177.7	1,177.7	1,177.7	1177.7
Retained reserves	2,400.6	2,375.4	2,358.8	2,817.2	1,959.3	1,917.2	1,926.8	2,732.4	2,692.2
Other reserves/subordinated debt	192.1	208.0	209.1	300.6	278.3	267.5	307.8	225.4	322.4
Profit – Loss (current year)	372.4	558.6	688.5	228.0	376.1	607.7	807.5	217.4	435.0
TOTAL SHAREHOLDERS' FUNDS	**4,645.7**	**4,822.6**	**4,937.0**	**5,029.4**	**5,150.3**	**5,333.6**	**5,620.2**	**5,787.6**	**6,052.7**
OFF BALANCE SHEET ITEMS (UGX. billion)									
Letters of credit	483.2	469.1	383.4	451.2	493.5	422.5	417.8	533.3	525.9
Guarantees & performance bonds	3,627.9	3,472.9	3,561.0	3,647.5	4,015.9	3,807.3	3,913.7	3,897.6	3,504.0
Unused loans/overdrafts commitment	2,725.6	2,387.9	2,687.4	2,991.0	2,879.2	2,953.9	3,521.3	3,633.3	3,443.2
Other off balance sheet items	359.7	312.9	416.7	479.4	839.9	1,073.3	1,199.4	767.9	521.9
TOTAL OFF BALANCE SHEET ITEMS	**7,196.3**	**6,642.8**	**7,048.5**	**7,569.1**	**8,228.5**	**8,257.1**	**9,052.2**	**8,832.2**	**7,994.9**

Source: Bank of Uganda

Appendix 3: Commercial banks' quarterly income statement, year-on-year figures

	June 2018	Sept 2018	Dec 2018	Mar 2019	June 2019	Sept 2019	Dec 2019	Mar 2020	June 2020
INCOME (UGX. billion)									
Interest income									
Advances	1,843.8	1,859.9	1,903.0	1,955.2	2,011.3	2,092.1	2,157.0	2,210.2	2,258.2
Government securities	625.6	607.5	609.0	636.7	676.8	710.3	729.3	750.0	769.8
Deposits abroad	28.8	31.5	34.9	39.1	46.2	57.3	65.2	68.4	60.2
Other	163.3	172.6	161.4	149.5	139.6	119.7	125.2	131.2	140.4
Charges, fees & commissions	500.0	509.2	518.0	524.7	551.4	563.4	581.2	620.7	590.1
Foreign exchange income	225.8	246.8	252.9	262.9	253.6	245.3	243.3	244.6	266.3
Other income	293.2	270.9	264.3	282.5	303.5	338.9	357.4	352.6	351.4
TOTAL INCOME	**3,679.9**	**3,698.3**	**3,743.6**	**3,850.5**	**3,982.4**	**4,127.1**	**4,258.5**	**4,377.8**	**4,436.3**
EXPENSES (UGX. billion)									
Interest expense on deposits	449.4	431.3	426.2	442.8	463.5	500.1	529.2	551.6	570.4
Other interest expenses	149.6	143.9	144.5	144.0	152.4	158.2	157.7	159.9	160.9
Provisions for bad debts	195.3	174.6	186.6	146.1	206.2	202.1	180.9	234.5	300.1
Salaries, wages, staff costs	800.6	815.1	834.4	857.8	870.5	890.3	912.0	924.6	931.1
Premises, depreciation, transport	338.5	345.9	349.6	535.6	356.1	364.7	371.8	383.9	390.7
Other expenses	744.5	773.6	824.0	828.9	850.9	864.7	914.1	950.2	941.3
TOTAL EXPENSES	**2,677.9**	**2,684.3**	**2,765.3**	**2,773.1**	**2,899.6**	**2,899.6**	**2,980.2**	**3,065.8**	**3,204.9**
ADD: Extraordinary credits/charges	0.0	1,303.8	2,202.0	2,202.0	2,202.0	898.2	-	-	-
Net profit before tax	1,002.0	1,012.7	976.1	1,075.2	1,080.6	1,146.1	1,192.8	1,172.8	1,141.7
LESS: Corporation tax	263.3	261.6	284.3	303.0	305.4	329.2	309.4	313.4	287.9
NET PROFIT AFTER TAX	**738.7**	**751.2**	**691.8**	**772.2**	**775.1**	**816.9**	**883.4**	**859.5**	**862.2**

Source: Bank of Uganda

Appendix 4: Selected quarterly financial soundness indicators for East African countries (percentage ratios)

		June 2018	Sept 2018	Dec 2018	Mar 2019	June 2019	Sept 2019	Dec 2019	Mar 2020	June 2020
Regulatory capital to risk-weighted assets	Uganda	21.8	21.6	21.6	22.3	21.3	21.4	21.8	21.9	22.7
	Kenya	18.0	17.5	18.7	18.4	18.2	18.3	18.8	18.5	
	Tanzania	20.2	18.3	18.2	17.8	18.1	18.0	17.6	18.0	17.9
	Rwanda	21.4	22.6	25.5	24.1	23.3	23.7	24.1	24.9	23.6
	Burundi	24.4	23.0	22.2	25.1	24.0	27.5	21.6	29.7	26.2
NPLS to total gross loans	Uganda	4.4	4.7	3.4	3.8	3.8	4.4	4.9	5.4	6.0
	Kenya	12.0	12.5	12.0	12.8	12.7	12.4	12.0	12.5	13.1
	Tanzania	10.3	9.7	10.5	10.9	10.7	11.1	10.1	11.0	10.8
	Rwanda	6.9	7.2	6.4	6.3	5.6	5.3	4.9	5.5	5.5
	Burundi	13.3	12.6	9.2	8.8	9.7	8.3	5.6	6.6	6.2
Return on assets	Uganda	2.8	2.8	2.5	2.8	2.7	2.8	2.9	2.8	2.6
	Kenya	2.8	2.7	2.7	3.0	2.8	2.7	2.5	2.3	
	Tanzania	1.6	1.6	1.0	1.7	2.0	1.8	1.8	2.0	2.2
	Rwanda	2.6	2.8	3.0	3.1	2.6	3.1	3.3	3.2	2.7
	Burundi	1.5	2.3	2.5	1.1	2.2	3.4	4.1	1.1	2.1
Return on equity	Uganda	16.7	16.3	14.4	15.9	15.8	16.1	16.7	15.9	15.2
	Kenya	23.7	22.9	22.5	24.6	23.8	22.5	21.2	20.4	
	Tanzania	6.7	6.6	2.8	7.4	8.8	7.8	6.6	8.5	9.9
	Rwanda	9.6	10.2	11.2	12.0	9.3	11.7	12.5	11.8	9.9
	Burundi	12.0	13.2	23.2	10.2	21.2	34.4	43.7	10.0	16.9
Foreign currency exposure to regulatory tier 1 capital	Uganda	-7.3	-5.0	-7.5	-4.3	-3.6	2.4	4.7	6.5	6.9
	Kenya	3.1	3.2	2.5	2.2	2.9	2.0	1.7	1.7	
	Tanzania	3.3	5.0	6.2	5.4	6.6	7.5	9.0	7.4	7.3
	Rwanda	-6.1	-10.2	-5.6	-7.1	-8.6	-5.3	-4.6	-3.3	-6.4
	Burundi	6.2	6.6	5.5	17.6	4.6	5.2	9.3	12.0	0.7
Liquid assets to total deposits	Uganda	46.6	43.9	45.5	44.1	45.5	50.3	48.6	48.8	49.1
	Kenya	50.5	52.6	46.6	49.8	48.7	50.5	53.2	53.8	
	Tanzania	45.4	41.9	42.7	42.1	45.7	43.1	41.0	37.7	39.0
	Rwanda	32.7	33.5	35.3	35.5	36.1	33.7	35.7	37.9	36.4
	Burundi	19.8	19.7	16.2	20.5	20.3	16.1	16.8	16.0	15.5

Source: EAC Partner State Central Banks