# FINANCIAL STABILITY RISK ASSESSMENT REPORT

**Presented at the Financial Stability Symposium**

**February 13, 2024**

BANK OF UGANDA

MISSION To Promote Price Stability and a Sound Financial System in Support of Socio-economic Transformation in Uganda.

# OUTLINE

- Summary of Key Risks to Financial Stability
- Overview of Banking Sector Risks and Resilience
- Performance of Payment Systems
- Update on Regulatory Developments & Ongoing Projects
- Outlook and Policy Implications

# 1. Summary of Key Risks to Financial Stability

| Risk category | Risk level: Dec-23 | Projected risk direction | Risk drivers and contributing factors |
|---|---|---|---|
| **Overall risk** | ● | ➡ | • Systemic risks moderated further during the quarter ended December 2023, reflective of improved macroeconomic conditions, relative stability in financing conditions, and strong capital and liquidity buffers held by SFIs. |
| **Macro risk** | ● | ➡ | • Macro risks eased further, reflected in lower inflation, and relative stability in the foreign exchange market. However, economic growth recovery is yet to fully reflect in banking institutions' credit extension and asset quality. |
| **Liquidity & funding risk** | ● | ⬆ | • Liquidity and funding conditions improved, partly due to the continued wearing-off of the tight monetary policy stance, increase in customer deposits, easing of wholesale funding cost.<br>• However, some banking institutions have concentration of deposits. |
| **Credit risk** | ● | ⬆ | • Credit growth continues to recover. The non-performing loans-to-gross loans (NPL) ratio reduced, partly attributed to prudent write-offs and growth in lending.<br>• However, a few banks with legacy loan affected by COVID-19 continue to report high NPLs. |
| **Profitability & solvency** | ● | ⬆ | • Aggregate capital buffers remained strong, and most banking institutions were compliant with the ongoing minimum regulatory capital requirements. However, NPLs and operational risk incidents may continue affecting some institutions' profitability. |
| **Market risk** | ● | ➡ | • Relative stability in foreign exchange rates and interest rates, which fostered improvement in funding conditions. Also, real estate property prices registered sustained moderate growth, which promises to minimize the banking sector's credit risk exposure. |
| **Structural risk** | ● | ⬇ | • The share of DSIBs in total banking sector assets reduced from 61.2% to 60.6%. BOU continues to ensure enhanced monitoring of DSIBs' performance and compliance with the various prudential limits. |

| Severity | High | Moderate | Low |
|---|---|---|---|
| Direction | ⇧ Increasing | ⇨ Stable | ⇩ Decreasing |

# 2. Composite Indicators of Systemic Risk

Fig.1: Systemic Risk Indicator

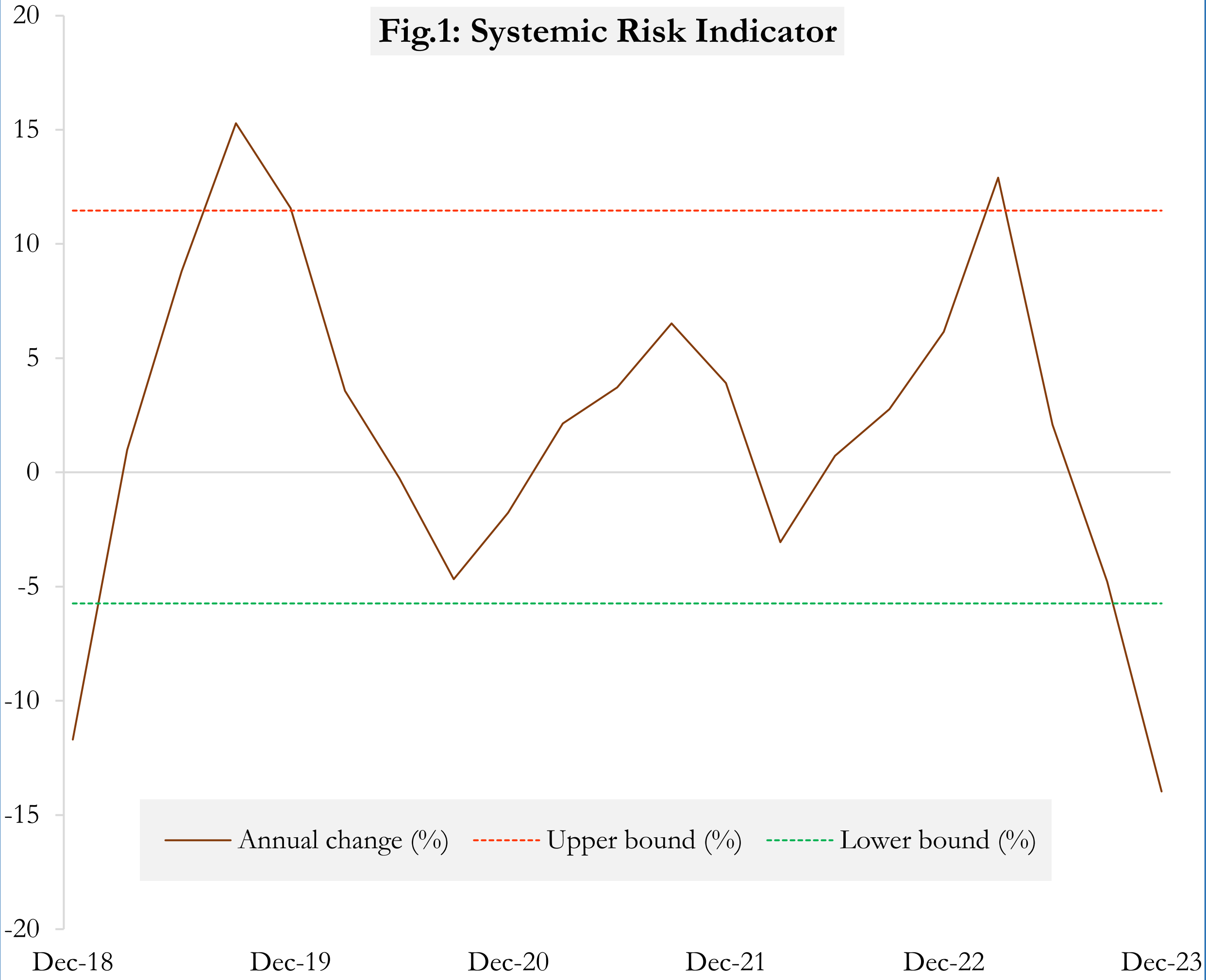
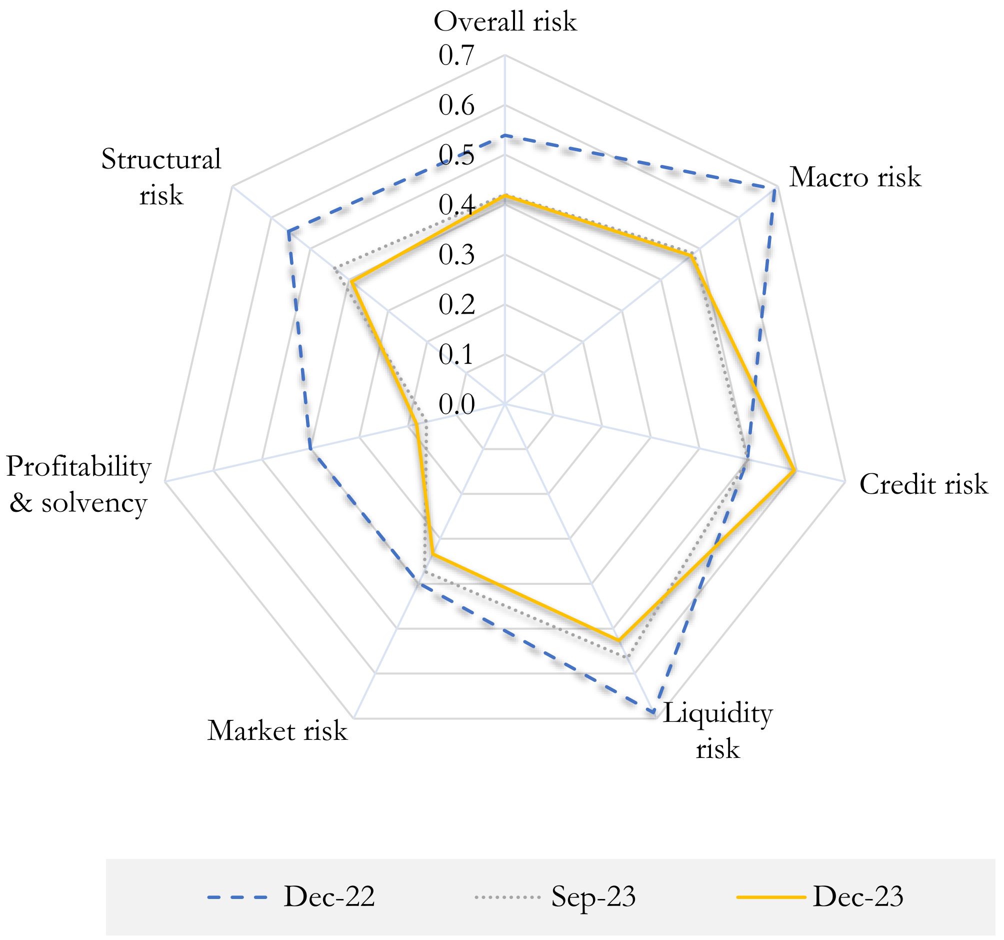



Fig.2: Systemic Risk Cobweb

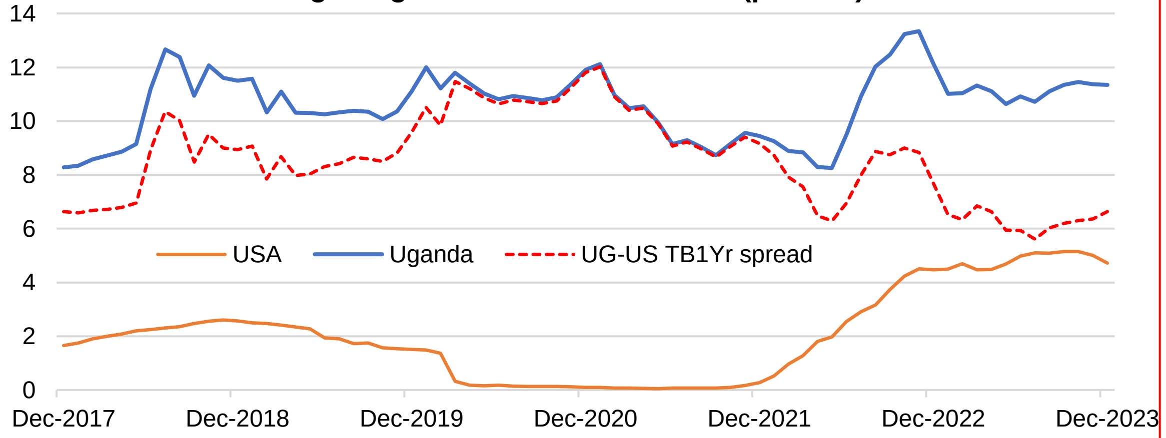


# 3. Macrofinancial Developments

## A. Global Developments

- Global economic growth is projected at **3.1% in 2024 and 3.2% in 2025**, however, below the historical (2000–19) average of 3.8 percent *(IMF WEO update, Jan.2024)*.
  - Inflation expected to **fall to 5.8% in 2024 and 4.4% in 2025, from 9.2% in 2022**.
- Financial conditions remained tight, as interest rates rose in Advanced Economies leading to moderate capital flow reversals from most EMDEs.
  - However, Uganda remained competitive, and total offshores' investments rose to UGX 4.02 trillion (Dec-23), an increase of 1.5% and 28.4% compared to Sep-23 and Dec-22, respectively.

Fig.3: Uganda vs. USA T/Bill 1YR (percent)




## B. Domestic Developments

- **Domestic economic growth remains on a recovery path**
  - GDP grew by 5.2% in FY2022-23, from 4.6% in FY2021-22 (*UBOS, 2023*).
  - BOU projects growth at 6.0% in FY23-24 and 6.5% in FY24-25 (*MPS, Feb.2024*)
- **Financial conditions were relatively stable, following easing of monetary policy**
  - Core inflation eased to 2.3% (Dec-23) from 2.4% (Sep-23) and 8.4% (Dec-22) but rose to 2.4% in Jan-24
  - UGX/USD remained relatively stable, depreciating marginally by 0.7% in Qtr-Dec.23 and by 1.8% in Year-to-Dec.23.
- **The aggregate banking sector assets increased by 9.3 percent, to UGX 51.3 trillion (Dec-2023) from UGX 46.9 trillion (Dec-2022).**

**IMPLICATIONS/OUTLOOK**:

- Improving global and domestic economic growth and financial conditions are expected support financial positions of households, firms, and government, leading to better banking sector performance.

# 4. Funding and Liquidity Conditions

**Liquidity and funding risk moderated during the quarter, supported by increased holdings of HQLAs.**

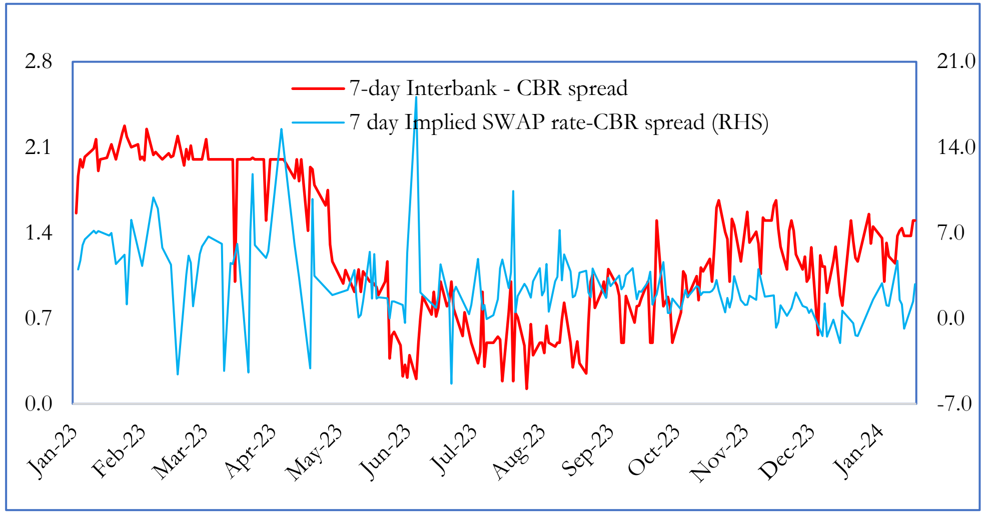
## Wholesale and Retail funding:

- Banks' customer deposits rose by 1.3% to UGX 34.7 trillion, compared to a reduction of 2.0% in Sep-23.
- Wholesale funding costs: the average Swap-CBR spread reduced from 2.79% to 1.22%, over the quarter ended Dec-23, supported by continued offshore investor activity and relative easing of monetary policy stance.

## Assessment of liquidity risk

- Liquidity buffers improved
  - Aggregate Liquidity coverage ratio (LCR) increased from 267.8% (Sep-23) to 285.2% (Dec-2023). All banks met the prudential minimum requirements of 100%.
  - Aggregate liquid assets-to-deposits ratio increased from 44.4% (Sep-23) to 45.0% (Dec-2023). All banks met the prudential minimum requirements of 20%.

**Fig.4: Spread between money market rates and the CBR (%)**




## BOU Action/ Outlook

- BOU has started implementation of the Financial Institutions (Liquidity) Regulations 2023, and this will enhance SFIs' liquidity and funding risk management.
- Recovery in economic growth and relative stability in financial markets is expected to further improve liquidity and funding conditions for banking institutions.

# 5. Credit Risk

- **<u>Credit growth continues to recover but remains soft</u>**
  - Total SFIs' loans grew by **<u>7.8% (UGX 1,548.4 billion)</u>** in the year to Dec-23, higher than the 5.4% growth in the year to Sep-23, however, lower than the 8.6% growth in Dec-22.
  - Credit growth across all sectors except for utilities and business.
- **Credit growth remains below long-term trend**
  - Credit growth continues to recover, and does not warrant raising the prudential countercyclical capital buffer (CCyB).

## <u>Asset quality improved in the quarter to December 2023.</u>

- The aggregate banking sector ratio of non-performing loans-to-gross loans (NPL ratio) **<u>reduced to 4.7% in Dec-23</u>**, from 5.4% in Sep-23 and 5.3% in Dec-22.
  - Reduction in NPLs partly reflects recovery on bad loans and prudent write-offs.

**<u>IMPLICATIONS</u>**:

- ❑ The improvement in asset quality (reduction in NPLs) is expected to further encourage banks to increase credit extension to the private sector, going forward.
- ❑ BOU continues to engage SFIs to enforce prudent credit risk management and mobilization of adequate capital buffers to absorb potential shocks.

**Fig. 5: Banking Sector Credit Growth, Annual (percent)**

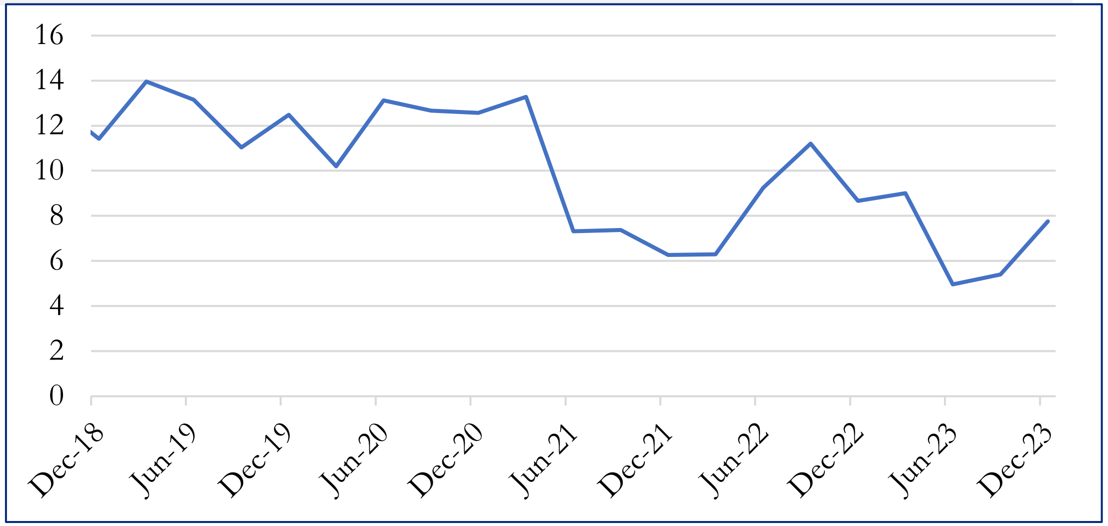
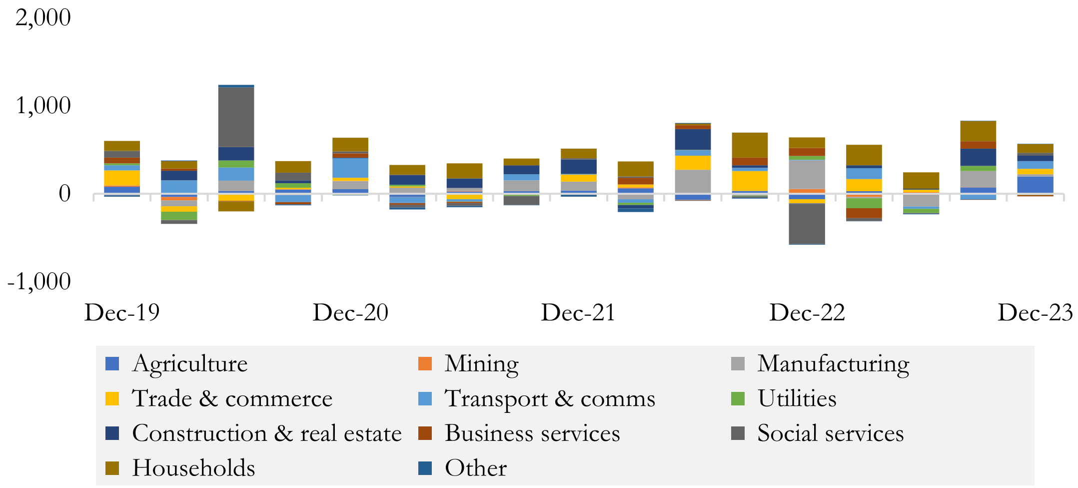



**Fig. 6: Quarterly changes in SFI Loans by sector (UGX billion)**



# 6. Capital Adequacy and Profitability

## Aggregate SFIs' capital buffers remained strong.

- Banks, CIs, and MDIs' aggregate core CARs stood at 25.3%, 20.1%, and 33.2%, well above the prudential minimum of 10%, 10%, and 15% respectively.
- *Leverage Ratio (6%) & Capital Conservation Buffer (12.5%/RWA):* All but 1 of the SFIs met the minimum requirements.
- *Systemic Risk Buffer:* All DSIBs were compliant.

## SFIs' profitability improved during the year.

- The aggregate net profit-after-tax (NPAT) increased by 23.9 percent to UGX 1.50 trillion for the year 2023 from UGX 1.21 trillion for 2022.
    - Profitability largely driven by the largest banks
    - The aggregate industry Return on Assets (ROA) improved from 2.75% (2022) to 3.19% (2023).

**IMPLICATION/OUTLOOK**:

- Most banks continue to maintain strong capital buffers to absorb potential shocks. However, high operational costs and cost of deposits continue to affect performance of some banks.

**Fig. 7: SFI core capital-to-RWAs ratios (percent)**

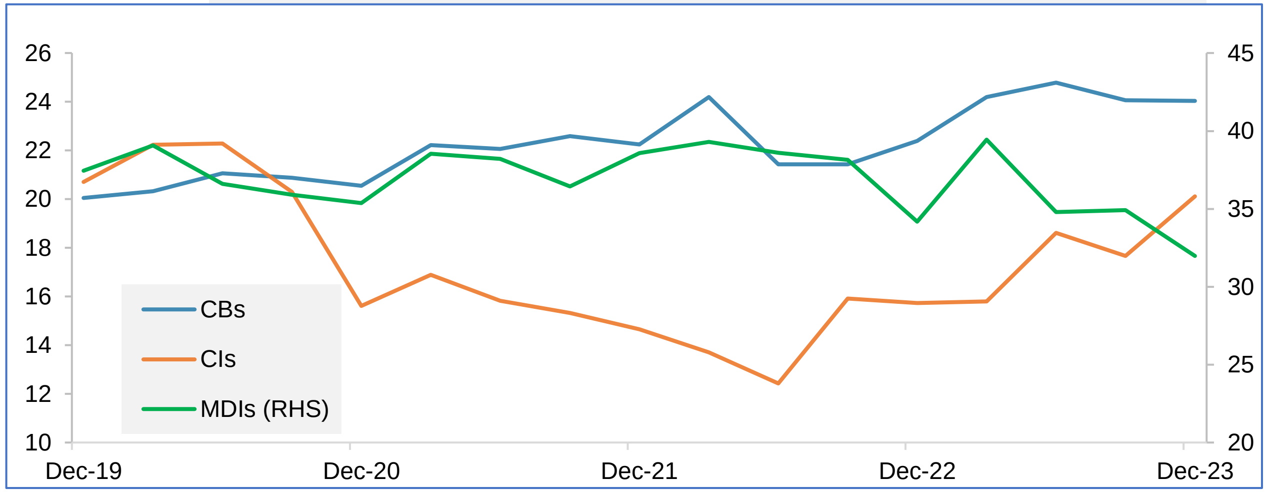
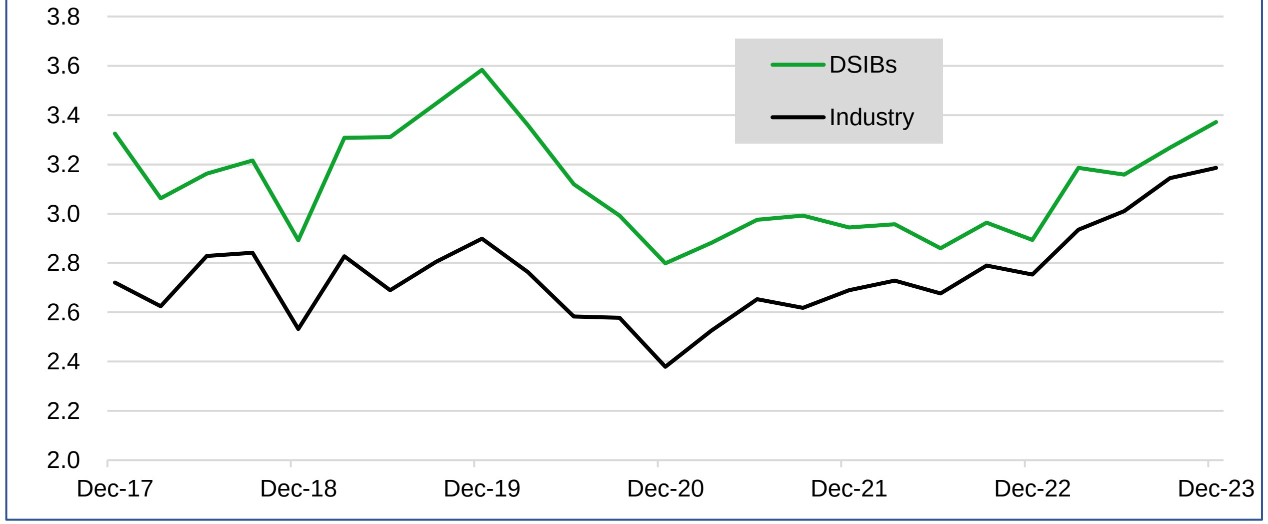



**Fig. 8: Banking sector Profitability: Return on Assets (percent)**



# 7. Market Risk

- **Market Risk: Relative stability in exchange and interest rates** during quarter.
  - All banks were compliant with the prudential limit on the ratio of the net open position in FX to core capital of +/-25%.
  - UGX remained stable against the US dollar despite depreciation pressures in quarter to Dec-23, minimizing exchange rate risk for banks.
  - The share of foreign-currency denominated loans and deposits in the banking sector's balance sheet has reduced over the years (Figure 10).

Fig 9: Banks' net open position to core capital (%)

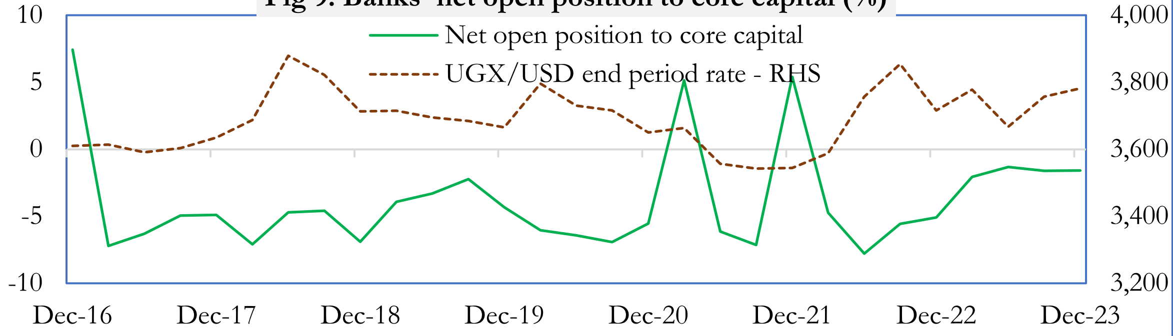
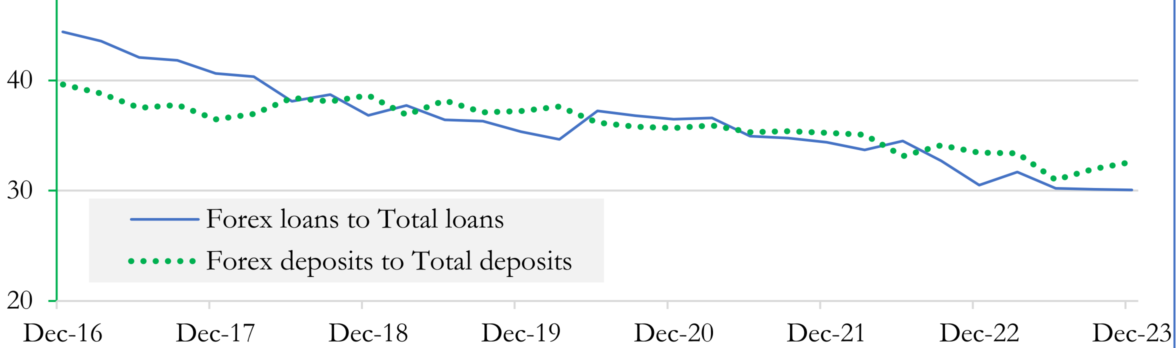
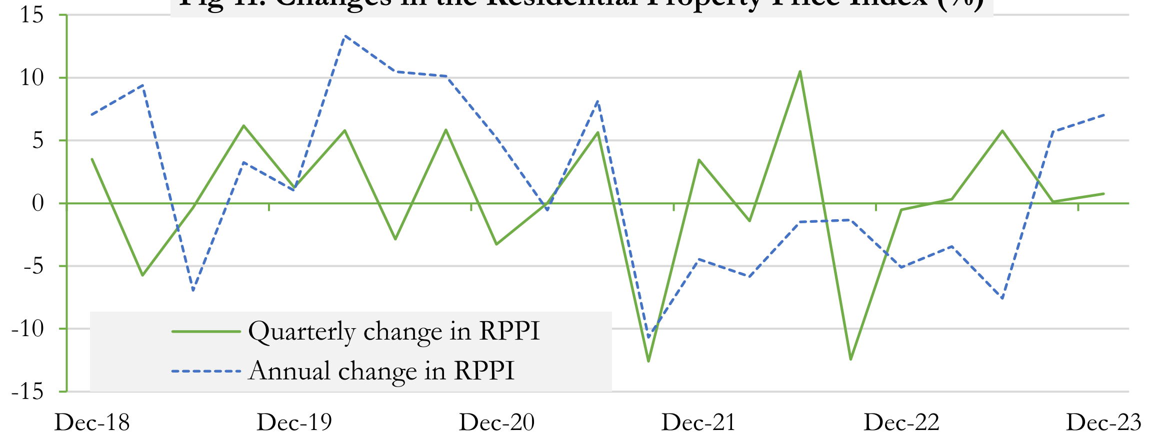



Fig 10: Banks' FX-denominated assets and liabilities (%)




- **Real Estate Market:**
  - The residential property price index (RPPI) shows consistent positive annual growth for the last 2 quarters, suggesting recovering real estate market prices.
  - Real estate loans increased by 1.5%, and account for 20% of gross loans. The sector NPL ratio eased from 6.0% to 5.6% over the quarter.

Fig 11: Changes in the Residential Property Price Index (%)



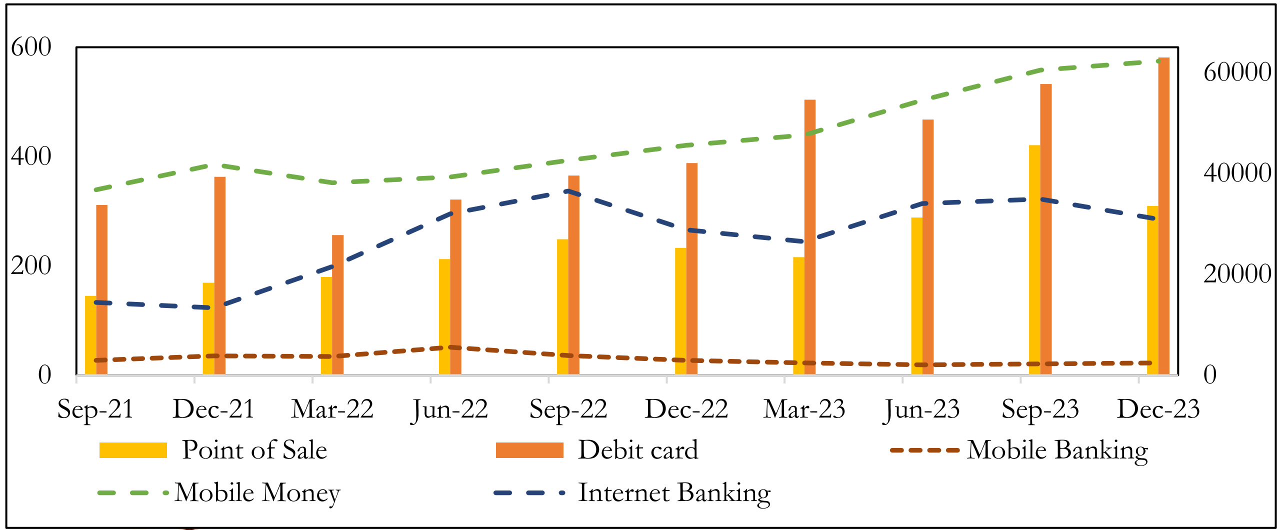

**OUTLOOK**

- Stability in the foreign exchange market and recovery in the real estate market is expected to minimize credit risk and support more lending to the private sector.
- BOU's prudential loan-to-value limit of 85% for residential mortgages and land purchase loans remains in place.

# 8. Payment Systems: Performance and Risks

- **Increased growth in the usage of digital payments**
  - **Debit cards payments**: The value of transactions increased by 9.1% from UGX 532.9 billion in Qtr-Sep-2023 to UGX 581.1 billion in Qtr-Dec-2023.
  - **Mobile Banking transfers**: The active number of users increased by 24.9% from 1.9 million in in Qtr-Sep-2023 to 2.4 million in Qtr-Dec-2023.
  - **Mobile Money**: The volume of transactions increased by 7.7% from 1.6 billion to 1.7 billion while the value of transactions increased by 2.9% from UGX 60.5 trillion to UGX 62.2 trillion.

**Fig 12: Quarterly Value of Transactions of Payment Systems (UGX billions)**




- **Liquidity risk was rated low in the quarter ended December 2023**
  - All electronic money is backed by funds held in trust accounts.
  - Bank accounts held at BOU were completely funded in advance to facilitate the settlement of RTGS transactions.
- **Operation risk was rated moderate in the quarter ended December 2023**
  - Low risk for Systemically Important Payment Systems
  - SIPS operated without significant disruption in the quarter ended December 2023.
  - Some fraud incidents remain in retail payment systems.

**BOU Action/ Outlook:**

- ❑ BOU continues to engage Payment services provider (PSPs) to address fraud and enhance cyber security and resilience practices.
- ❑ The revised Interception of Communications Regulations, 2023 came into force. This expected to mitigate fraudulent activities, with limits on the number of sim cards an individual can own.
- ❑ BOU will continue with public awareness and sensitization on risks in digital payments.

# 9. Update on Regulatory Developments & Ongoing Projects

**A. Financial Institutions (Amendment) Bill, 2023**

- Assented to by H.E President on August 21, 2023, repealing section 115B (2) that established the Central Shari'ah Advisory Council.
- Salaam Bank licensed as an Islamic Bank on 8th Sep 2023.

**B. Microfinance Deposit-Taking Institutions (Amendment) Bill, 2022**

- Amendments to the MDIs Act 2003 were assented to in May 2023.
- These introduced Islamic microfinance, agent banking, bancassurance for MDIs and BOU has now started drafting the implementing regulations.

**C. MDI (Registered Societies) Regulations 2022 & Supervision of Large SACCOs**

- Regulations were gazetted in June 2023, allowing registered societies (large SACCOs).
- However, in August 2023, the Uganda Cooperative Savings and Credit Union (UCSCU) filed a petition against BOU & the Attorney General, contesting BOU's large SACCO mandate.

**D. Environmental, social, & governance (ESG) Supervision**

- BOU is working with the Uganda Bankers' Association (UBA) to develop an ESG framework, covering: current state assessment, governance, sustainable finance, risk management, and reporting and disclosure.

**E. Financial Institutions (Liquidity) Regulations 2023**

- Regulations 2023 were gazetted on August 11, 2023.
- Regulations will enhance banks' liquidity risk management, incorporate Basel III standards for LCR and NSFR, and update the list of liquid assets reflecting the financial sector's evolution.

# 10. Outlook and Policy Implications

a) **Overall, systemic risks continued to moderate during the quarter ended December 2023. The banking sector remains stable and resilient to potential shocks, underpinned by strong capital and liquidity buffers held by most SFIs.**

- More robust economic growth, as projected by Bank of Uganda (Monetary policy statement, February 2024) is expected to alleviate non-performing loans, and foster banking sector lending to the private sector as well as improve profitability.

- Easing of monetary policy stance and exchange rate stability are expected to support more accommodative funding conditions.

b) **The outlook is for conditions in the banking sector to improve over the FY 2023/24.**

- Banks are required to further buffer-up paid-up capital to a regulatory minimum of UGX 150 Billion, by 30th June 2024 and most are on course.

| Policy Measures by BOU | Justification |
|---|---|
| a) BOU has started implementation of the Financial Institutions (Liquidity) Regulations 2023 | • This will enhance banking institutions' liquidity and funding risk management.<br>• Also aligns with international standards, i.e. the Basel III framework |
| b) Maintain Loan-to-value limit of 85.0% on residential mortgages and land purchase. | • To mitigate excessive leverage by borrowers and limit SFIs' exposure to adverse real estate prices developments. |
| c) Maintain countercyclical capital buffer (0%/RWA). | • Economic indicators and the credit cycle do not point to a need to vary buffer. |

# 11. Discussion and Q&A