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EDS.B.66

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Circular to all Commercial Banks and Credit Institutions

Additional Guidance Note on Mortgage Banking Class

Following our circular EDS.B.66 dated 2nd October, 2006 titled **Guidance Note on Mortgage Banking Class,** there has been considerable interest by banks and credit institutions wishing to engage in one or more such mortgage banking activities, especially as to the granting of loans for various purposes relating to mortgage lending in general.[1] In this connection, BOU wishes to expand on this circular and explain prudent measures that should be taken by banks and credit institutions engaged in mortgage lending. These measures are highlighted below:

- All banks and credit institutions engaged in mortgage lending must take into account the following risks:

1) Liquidity risk (maturity transformation)
2) Legal risk
3) Interest rate risk
4) Credit risk (including the impact of high interest rates)

The Bank of Uganda expects banks and credit institutions engaging in mortgage lending to establish their own criteria and policies to identify, measure, monitor, and control the risks involved with this type of lending. For its own part, the BOU, through both its on-site and off-site supervision, will review the adequacy of banks and credit institutions risk management systems regarding mortgage lending.

1) Liquidity risk (maturity transformation)

At present, banks and credit institutions have, in general, short-term maturities, meaning short-term funding for short-term assets. Given that mortgage lending is expected to have some original maturities of 10 to 20 years, the issue of maturity transformation has to be taken into consideration.

Some banks have indicated that their own historical research shows a large percentage of their deposit base as "core deposits" by their own internal definitions. This means while maturities may be short-term, a large portion of funding remains on deposit for a

[1] For the purposes of this circular, the use of the term "mortgage lending" means the granting of real estate loans, be they for residential, commercial, or construction purposes, which are secured by a document known as a mortgage allowing the lender to take possession of the real estate in the event of a default.

much longer term, especially as to current accounts and savings accounts. In addition to core deposits, BOU encourages banks and credit institutions to seek longer term funding, including subordinated obligations for mortgage lending.

2) Legal risk

Lending against the security of real property (the mortgage itself) depends on two main factors: 1) the ability through the legal system for the bank to acquire (take title) to the property; and 2) the market for such property is sufficient to enable the bank to make full recovery through sale of its collateral (the real estate). Bank of Uganda expects banks and credit institutions to closely monitor legal risk with regard to realisation of collateral.

3) Interest rate risk

Lending on a long-term basis, as mortgage lending will involve, assumes interest rate risk, so long as the loan is on a fixed rate basis. During the life of the mortgage loan, if interest rates rise, the shorter-term sources of funding will rise, and the bank's interest margins if the loan is fixed rate, will be adversely affected through interest rate risk.

While the BOU is reasonably confident that banks engaged in mortgage lending can manage interest rate risk through repricing or other methods to hedge against interest rate movements, we expect banks to understand this risk and manage it accordingly.

4) Credit risk (and pricing considerations)

Credit risk must be considered a major factor in lending when original maturities are in the long-term, such as 10 to 20 year range for much of mortgage lending. While the borrower may look qualified in the short-run (such as using a percentage of his or her earnings for debt service), much can change over the life of the mortgage loan.

Bank of Uganda will closely monitor the pricing of mortgage lending including interest rates and fees charged. Bank of Uganda will seek to discuss with banks the level of interest rates and bank charges as part of its encouragement of the lowest possible charges to make mortgages affordable to more Ugandans.

J. Bagyenda (Mrs)
Executive Director Supervision

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