## ABBREVIATIONS AND ACRONYMS

| | |
|---|---|
| BCM | Business Continuity Management |
| BOU | Bank of Uganda |
| BS 100 | Monthly Asset and Liabilities Reporting Form for Banks and Credit Institutions |
| CID | Criminal Investigations Department |
| CRB(S) | Credit Reference Bureau (Services) |
| FEA 2004 | Foreign Exchange Act of 2004 |
| FER 2006 | Foreign Exchange Regulations of 2006 |
| FIA 2004 | Financial Institutions Act of 2004 |
| FSD | Financial Stability Department |
| FXB | Forex Bureau |
| MAC | Monetary Affairs Committee |
| EAC | East African Community |
| GTZ | Gesellschaft für Technische Zusammenarbeit |
| KCB | Kenya Commercial Bank |
| MDI | Microfinance Deposit–taking Institutions |
| MDI 100 | Monthly Asset and Liabilities Reporting Form for MDIs |
| MDI Act 2003 | Microfinance Deposit–taking Institutions Act of 2003 |
| MDI-DPF | Microfinance Deposit–taking Institutions Deposit Protection Fund |
| MoU | Memorandum of Understanding |
| MR | Money Remittance |
| MTN | Mobile Telephone Network |
| NGO MFI | Non Government Organisation type of MFI |
| PI(s) | Participating Institutions |
| RBS | Risk Based Supervision |
| RMGs | Risk Management Guidelines |
| SACCO | Savings and Credit Cooperative |
| SFI | Supervised Financial Institution |
| Tier 4 | Microfinance Institutions not supervised by BoU |
| UBA | Uganda Bankers' Association |
| UTL | Uganda Telcom Limited |

## TABLE OF CONTENTS

## FOREWORD

The global financial crisis heightened the risks facing financial systems around the world and created challenges for financial regulators. I am pleased to report that the Ugandan financial sector has stood up well to the shocks from the global financial crisis. The main reasons for this are prudent management on the part of commercial banks and intensified risk based supervision on the part of the Bank of Uganda (BOU). As a consequence, the banking system remains profitable and liquid. It also holds regulatory capital which is much higher than the statutory minimum.

In response to the threats arising from the global financial crisis, the BOU stepped up its supervision of financial institutions. Particular attention was paid to their external exposures as well as credit concentration. In addition, stress tests were carried out on all of the banks operating in Uganda to determine the extent, if at all, to which their capital would be impaired in the event of adverse shocks. The BOU also took steps to encourage stronger risk management in banks.

One of the key lessons learned from the global financial crisis is that micro-prudential supervision (the supervision of individual financial institutions) is not always sufficient to ensure the stability of the financial system as a whole. Accordingly, the BOU established a Financial Stability Department to monitor and analyse systemic risks to the financial system. In early 2010, the Financial Stability Department produced its first Financial Stability Report.

The Annual Supervision Report provides an account of the main supervisory activities related to the financial sector which were undertaken by the BOU in 2009. The purpose of the report is to strengthen public understanding of issues pertaining to the supervision of financial institutions and of the BOU's role as regulator. The report aims to enhance the transparency of financial regulation. As such I hope that it will both bolster public confidence in the soundness of the financial system and contribute to the accountability of the BOU to the public.

E. Tumusiime-Mutebile (Prof.)
**GOVERNOR**

## EXECUTIVE SUMMARY

The global financial system faced unprecedented turbulence in the final quarter of 2008, arising from the systemic instability of financial systems in several major developed economies. Because of the threat of contagion from the global financial crisis and the impact of the global recession, BOU intensified its surveillance of supervised financial institutions, to ensure that the Uganda financial system remained both solvent and liquid. Ugandan banks were able to weather the direct impact of the global financial crisis without serious repercussions, mainly because their exposure to toxic assets and distressed financial institutions abroad was negligible and because they had very little dependence on external short term borrowing to fund their asset holdings. However the growth of the Ugandan banking system decelerated in 2009, from the very rapid levels recorded in 2007 and 2008, as a result of slower growth in economic activity in Uganda; this was accompanied by minimal rise in non-performing loans and a decline in the average return on assets. Nevertheless, the capital adequacy of the banking system remained very strong, with core capital equivalent to nearly 19 percent of risk weighted assets at the end of 2009.

All supervised financial institutions (SFIs) were subject to off-site monitoring by the BOU carried out through the analysis of financial data submitted at regular intervals. Particular attention was paid to the exposure of Ugandan banks to foreign financial institutions, including their correspondent banks, and to the asset concentration of banks. BOU also implemented quarterly stress tests on banks to evaluate the impact on their capital of adverse shocks. During 2009 BOU carried out full scope risk based on-site examinations of 18 banks. In some cases, on-site examinations revealed weaknesses in risk management and corporate governance, prompting BOU to issue recommendations to the banks concerned to undertake remedial measures. In addition, BOU also initiated monthly monitoring of the capital position of the banks which had become undercapitalized. Furthermore, BOU carried out on-site inspections of the 4 credit institutions and 3 deposit taking microfinance institutions.

During 2009 BOU issued new regulatory guidelines pertaining to outsourcing of services by SFIs and to treatment of income arising from unrealized gains in the computation of regulatory capital. BOU also revised the risk management guidelines issued to SFIs. A new reporting format for SFIs to submit financial data was introduced and became operational at the start of 2010.

No new banks, credit institutions or MDIs were licensed in 2009, leaving the numbers in operation at 21, 4 and 3 respectively. However BOU licensed the opening of 61 new outlets (branches, sub-branches and agencies) by banks, credit institutions and MDIs.   BOU also approved the introduction of mobile telephone banking products by three banks, each in collaboration with a mobile phone service provider.

One of the most important lessons of the global financial crisis was that micro-prudential supervision (the supervision of individual financial institutions, is not always sufficient to provide forewarning of, or to prevent, a systemic banking crisis. Accordingly the BOU established a new department of financial stability, within its supervision function, to monitor and analyse threats to the systemic stability of the financial system.

BOU investigated 10 complaints from the public of unlicensed financial activity, including illegal deposit taking, the operation of pyramid schemes and the illegal use of the term “bank”. As a result of its investigations the bank accounts of pyramid schemes were frozen and evidence of fraudulent activities was passed to the Criminal Investigations Department of the Uganda Police.

The signing of the protocol for the East African Common Market, which came into effect on July 1st, 2010, has increased the importance of harmonizing financial regulations at the regional level and strengthening cooperation between the financial regulators in the EAC. Within the EAC, responsibility for the harmonization of financial sector policy and regulation lies with the Monetary Affairs Committee (MAC).  Under the program which MAC initiated to harmonize supervision methodologies within the EAC, supervisors from each central bank participated in on-site bank inspections carried out by their counterparts in other EAC countries.

# 1. CHALLENGES IN FINANCIAL SECTOR SUPERVISION

## The Global Financial Crisis and Slowdown in the Domestic Economy

Financial supervisors around the world faced unprecedented challenges in 2009 as a result of the systemic financial crisis which had erupted in developed economies in the previous year. The nature and scale of the global financial crisis and its subsequent impact on the global economy meant that few financial markets, anywhere in the world, could be confident of avoiding the repercussions.

For Uganda, there were two main channels through which the global financial crisis could potentially affect the domestic banking sector: directly through contagion and indirectly through the impact of the global recession on the health of the Ugandan economy.

The contagion channel had very little impact on the domestic financial sector in Uganda, primarily for two reasons. First, Ugandan banks had minimal exposure on the asset side of their balance sheet to the type of toxic assets which had caused so much damage in other countries or to distressed financial institutions abroad. Uganda banks' holdings in foreign assets amounted to only 12 percent of total assets comprising of claims on foreign banks at the end of 2008. However, most of these foreign assets were deposits in correspondent banks which remained in sound condition during the global crisis. Secondly, Ugandan banks do not rely on mobilising short term finance from foreign financial institutions to fund their asset portfolios; their liabilities to foreign financial institutions were only 4 percent of their total liabilities at the end of 2008. Hence Ugandan banks were not vulnerable to a sharp loss of liquidity when the credit crunch in developed economies triggered a reversal of financial flows to emerging and frontier markets.

The indirect impact of the global financial crisis was mediated through its effects on the broader Ugandan economy; effects which are still being felt. Economic growth in Uganda slowed down in 2008/09 and 2009/10, as a result of weaker external and domestic demand. As a consequence of the weaker economic growth, the very rapid growth in assets and profitability which had characterised the banking sector in 2007 and 2008 slowed markedly in 2009. Growth in the total assets of the banking system fell from 35 percent in 2008 to 16 percent in 2009. The banks also suffered an increase in non performing loans, from 2.2 percent of gross loans at the end of 2008 to 4.2 percent at the end of 2009, which is also at least partly attributable to the weaker economic conditions. However the rise in non performing loans was not large enough to seriously threaten the financial soundness of the banking system.

The profitability of the banking system, as measured by the average return on assets, fell from 3.5 percent in 2008 to 3 percent in 2009. Nevertheless, the banking system in aggregate not only remained profitable but generated sufficient profits to maintain its core capital to risk weighted asset ratio at 18.7 percent at the end of 2009, the same level as at the end of 2008. Consequently, the banking system in aggregate remained in a very sound financial condition in 2009.

Appendix 1 presents financial soundness indicators for the Ugandan financial system in 2008 and 2009.

### Increased Competition in the Financial Sector

Since the removal of the moratorium on the licensing of new banks in 2007, the BoU has licensed 7 new commercial banks and one credit institution, raising the number of commercial banks to 21 and credit institutions to 4 by 2009. The financial system has exhibited signs of becoming more competitive, notably through aggressive branch expansion and introduction of new products. However, increased competition and the introduction of new products, including mobile telephone products, has potentially increased the risks facing financial institutions. As a result it is essential that supervised financial institutions (SFIs) continuously strengthen their risk management systems to ensure that they keep pace with the evolving nature of risk that these institutions face.

Competition in the forex bureau (FXB) and the money remittance (MR) subsector also intensified with the licensing of 27 new entrants in 2009. This brought the total number of FXB outlets to 135 and MR outlets to 91.

## 2. SUPERVISION OF FINANCIAL INSTITUTIONS

BOU responded to the challenges described above by strengthening its surveillance of commercial banks, with particular attention paid to their exposures to foreign financial institutions, such as correspondent banks.

### Off site Inspection

All SFIs are subject to off site monitoring, carried out through analysis of mandatory statutory returns of financial data which are submitted to BOU on prescribed periodic basis. Because of the heightened risks emanating from the global financial crisis, BOU closely monitored the exposure of Ugandan banks to their correspondent banks abroad, through a weekly survey. This enabled the BOU to determine that the exposure of Ugandan banks to their correspondent banks remained relatively modest and did not pose a serious risk to their financial soundness. BOU also carried out a monthly survey of the credit concentration in banks.

The 2008 audited financial statements of all SFIs were reviewed and approved by BOU prior to publication.

### Stress Testing

Using the returns submitted by banks, BOU conducted stress tests to estimate the losses which banks would incur, and the consequent impact of these losses on their capital, in the event of specific shocks. The stress tests were designed to evaluate the impact of the following shocks:

i) decline in net interest margin,

ii) increase in non performing loans,

iii) decrease in interest income on government securities,

iv) depreciation of the Uganda shilling against the US dollar, and

v) 100 percent loan loss of each bank's largest borrowers.

The stress tests were conducted at the end of each quarter in 2009. The results of the tests conducted on the banks' financial positions as of December 2009 are shown in Table 1. As can be seen in the table, an adverse shock to net interest income, income received from government securities, an increase in NPLs and a depreciation of the Ugandan Shilling all have roughly similar impact on the capital position of the banking system. For each of these shocks, the capital adequacy of 2-3 individual banks is pushed below the statutory minimum, with the overall capital shortfall being in the region of Shs 4-5 billion. This is small in the context of a banking system with aggregate capital of Shs 1,381 billion at end December 2009.

However, default by the banks' largest borrowers has a much more serious impact, reflecting the fact that the main risks facing the banking system are credit risks and that credit concentration is relatively high. If each banks' single largest borrower were to default, with a loan loss of 100 percent, five banks would become undercapitalised with an aggregate capital shortfall of Shs 15 billion. If the three largest borrowers of each bank were to default with 100 loan loss, which represents a very low probability shock – a so called tail event – 13 banks would be undercapitalised with an aggregate capital shortfall of Shs 203 billion.

**Table 1: Stress Test Shock for Quarter Ended December 31, 2009**

| Stress Test Variable | Number of banks[1] | Aggregate Additional Capital Shs. (Billions)[2] |
|---|---|---|
| Decrease in Net Interest Income by 20% | 2 | 4.1 |
| Decrease in Net Interest Income by 50% | 3 | 5.1 |
| Decrease in income from Government Securities by 20% | 2 | 4.5 |
| Decrease in income from Government Securities by 50% | 2 | 4.9 |
| Depreciation of Ushs. against US Dollar by 20% | 2 | 4.2 |
| Depreciation of Ushs. against US Dollar by 30% | 2 | 4.3 |
| Increase in NPL by 30% | 3 | 4.5 |
| Increase in NPL by 50% | 3 | 5.5 |
| Default by single largest borrower | 5 | 14.8 |
| Default by 3 largest borrowers | 13 | 203.0 |

## On site Inspection

BOU conducted a full scope risk-based onsite examination of 18 commercial banks during 2009. During these examinations, supervisors evaluated whether the global financial crisis had adversely affected the banks' financial condition and assessed the adequacy of corrective measures that these banks were taking to mitigate their risk exposures.

[1] whose capital falls below statutory minimum
[2] required by the affected banks

The inspections revealed that all the banks had posted commendable efforts in instituting credible corporate governance and risk management practices. Furthermore the capital adequacy compliance was overall satisfactory.

After every onsite inspection of a bank, BOU held a mandatory exit meeting with its senior management and board of directors. The aim of the meeting was to clarify key issues of supervisory concern to board members and to encourage the board to ensure that the management fully implemented any remedial actions which had been recommended by the supervisors.

The BOU also carried out on site inspections of credit institutions, microfinance deposit-taking institutions, forex bureaux and money remittance businesses. Two full scope risk-based on-site examinations and two follow-up examinations were conducted on the four credit institutions in 2009. The two follow-up examinations of credit institutions were carried out to monitor whether they had complied with recommendations made by BOU following full scope on-site examinations in the previous year. Both credit institutions had complied, in most respects, with BOU's recommendations. The two credit institutions which were subject to full scope on-site examinations were in compliance with statutory requirements.

The on-site examinations of the three MDIs revealed that they were compliant with most of the regulatory provisions and guidelines.

During the year, the BOU conducted on-site examinations of 122 FXB and 87 MR businesses to determine the level and extent of compliance with the provisions of the Foreign Exchange Act (FEA) 2004 and the Forex Bureau and Money Remittance Regulations of 2006 (FER), as well as the guidelines and circulars issued by the BOU. Most of the licensed FXBs and MRs were complying with the regulations and guidelines.

## 3. REFORMS TO STRENGTHEN SUPERVISION

### Guidance to SFIs

#### Outsourcing

The BOU issued a Guideline on Outsourcing by SFIs in March 2009. Outsourcing involves the contracting out of specific functions by a SFI to another company. The guideline was motivated by the recognition that outsourcing poses various types of risks to SFIs. Prior to the issuance of the Guideline by BOU, there were no specific prudential requirements related to outsourcing by SFIs, other than a general understanding that BOU would be advised in advance by SFIs of any significant outsourcing proposals.

The overall aim of the Guideline is to ensure that senior management and board of each SFI retain control and accountability for all outsourced functions and that the SFI's compliance and audit (internal and external) adequately monitor the outsourced functions.

Specifically, the Guideline requires all SFIs to put in place an Outsourcing Policy. SFIs must assess the ability of service providers, ensure that board and management retain accountability for outsourced activities, and effectively monitor and control outsourced services. SFIs must undertake a comprehensive risk assessment of outsourcing arrangements. They must ensure that outsourcing agreements clearly set out the contractual liabilities and obligations of all parties. SFIs must also ensure that outsourcing agreements comply with customer confidentiality requirements. In addition, SFIs must put in place contingency plans in case of a breakdown of service delivery.

#### Treatment of Unrealised Gains in the Computation of Regulatory Capital

BOU observed that some SFIs were incorrectly including income from unrealised gains arising from the revaluation of assets in the computation of their regulatory capital. This is contrary to the 1988 Basel Capital Accord, the FIA 2004 and the capital adequacy regulations issued by BOU. Unrealised gains do not provide resources which a SFI can use as a buffer to protect its deposits against losses.

To rectify this, BOU issued a guideline to all SFIs which stipulated that unrealised gains must be deducted from regulatory capital for the purposes of computing the SFI's capital adequacy position. In addition, SFIs are not allowed to distribute dividends from any income which is derived from unrealised gains.

#### Risk Management Guidelines

BOU reviewed the Risk Management Guidelines (RMGs) issued to SFIs in 2002. The purpose of the review was to incorporate new risk areas into the guidelines and emphasise the need for stress testing and business continuity planning within SFIs.

In addition to the coverage of credit and liquidity risks, the new RMGs were expanded to include strategic risk, compliance risk and country risk. The guidelines stipulate that the SFI conducts a stress test for all five of these risk categories.

### Monthly Reporting Format

BOU revised the reporting formats for the submission of data on assets and liabilities by SFIs on a monthly basis. The reporting format for banks and credit institutions is called the BS 100 and that for MDIs is called the MDI 100. The reporting formats were revised to expand the scope of data captured and its disaggregation, which is necessary because of changes in economic activities within the country. The revision also realigned the reporting formats with changes in international accounting and reporting standards.

BOU provided training to the SFIs on the revised reporting formats, which will be rolled out at the beginning of January 2010.

### Internal Audit Reports

To strengthen the risk based methodology, BOU requested all SFIs to submit a copy of their approved annual audit programme, a copy of the report of every quarterly internal audit and reports of any special audits carried out. The review of internal audit reports is critical to developing and maintaining an in-depth understanding of emerging internal control weaknesses and risks and as such they are used by BOU to facilitate the planning of on-site inspections.

### Anti Money Laundering

An Anti-Money Laundering Bill was submitted to Parliament but has not yet been enacted. In the meantime, BOU uses the Anti Money Laundering Guidelines issued in 2002 to ensure that SFIs strengthen their anti-money laundering measures. BOU re-emphasised to the SFIs the requirement to report all suspicious transactions as well as to carry out internal investigations on all suspicious transactions and report any criminal activities to the law enforcement agencies.

## Deposit Protection

The arrangements for the operationalisation of the MDI Deposit Protection Fund (MDI-DPF) were completed in 2009, enabling it to become operational in January 2010. The MDI-DPF provides protection to deposits in MDIs up to a maximum of Ug shs 3 million per depositor.

## Licensing and Approvals

### Licensing of branches, sub-branches and agencies

No new commercial banks, credit institutions and MDIs were licensed during 2009, therefore the number of licensed deposit taking institutions remained at 28 (21 banks, 4 credit institutions and 3 MDIs). SFIs must seek permission from BOU before opening a new outlet (branches, sub-branches and agencies). In 2009, the total number of outlets for deposit taking institutions increased by

61, from 424 to 485. A total of 32 new outlets of FXB and MR businesses were licensed during in 2009. The numbers of outlets in each category of SFI at the end of 2008 and 2009 is indicated in table 2.

**Table 2 Licensed Outlets 2008 and 2009**

| Type | No of Outlets | | Remarks |
|---|---|---|---|
| | 2008 | 2009 | |
| Banks | 301 | 364 | 40 branches by Equity Bank (previously UML MDI) |
| CIs | 27 | 45 | 18 new outlets by the newly licensed Opportunity International |
| MDIs | 96 | 76 | Though new outlets were opened, moving the 40 UML branches to bank category, led to an overall reduction in MDI outlets |
| **Sub Total** | **424** | **485** | **Overall increase of 61 outlets in deposit taking institutions** |
| FXB | 114 | 135 | Due to some outlets combining FXB and MR businesses, total new outlets opened were 32 |
| MR | 80 | 91 | |

**Source: Various Supervised Institution Reports**

## Change of Name

Faulu Uganda Limited, a Credit Institution, which was licensed in December 2008, applied and was granted permission to change its name to Opportunity Uganda Limited to take advantage of the internationally known Opportunity brand (given that Opportunity International is the majority shareholder). The change also enabled Faulu to distinguish its credit institution business from other Faulu Companies, which are not under the Opportunity International network.

## Acquisitions and Amalgamations

BoU approved the acquisition of an 80 percent shareholding in Orient Bank Limited by Bank Phb Plc. of Nigeria. BoU also approved the acquisition of Capital Finance Corporation Limited (a credit institution) by ABC Capital Bank Limited of Kenya. The latter was subsequently granted a banking license, in early 2010, enabling Capital Finance Corporation Limited to be converted into a commercial bank.

## Approval of new products

### Mobile Money

BOU approved three mobile telephone money transfer products, which entailed banks partnering with mobile phone network providers to roll out mobile/cellular phone payment systems. The partnerships were; Mobile Telephone Network (MTN) with Stanbic Bank; Zain with Standard Chartered Bank and Uganda Telecommunication Limited (UTL) with Dfcu Bank. Two more mobile phone network providers have indicated that they are planning to engage in the Mobile Money Transfer business during 2010.

Money transfer via mobile phones has expanded rapidly. By the end of 2009 there were over 400,000 registered users of mobile money transfers in Uganda, with monthly transactions amounting to Shs 30 billion.

### Mobile Banking

Centenary Rural Development Bank obtained BOU approval to establish a mobile banking service to be operated from an all terrain four-wheel drive mobile unit. The mobile banking service will offer limited services such as savings and current account opening and maintenance, limited cash withdrawals, issuance of bank statements, receipt of cheques and initiation of money transfer requests for handling at the respective parent branches. It is envisaged that the service will provide a more cost-effective model of increasing outreach in rural areas where, due to poor infrastructure, no formal banking services currently exist.

## 4. FINANCIAL STABILITY DEPARTMENT

BOU established the Financial Stability Department (FSD) in July 2009 to analyse and monitor systemic risks to the financial system. The role of the FSD is distinct from that of commercial bank and non bank supervision. The commercial bank and non bank supervision departments of the BOU implement microprudential supervision, which focuses on the financial soundness of each individual SFI. In contrast, the FSD focuses on macroprudential supervision which is focussed on the soundness of the financial system as a whole rather than on its individual components.

The rationale for macroprudential supervision is that microprudential regulation alone is not always sufficient to prevent systemic risks to the financial sector. This is because financial institutions can act in ways which are individually rational (and comply with prudential regulations) but which collectively can undermine the soundness of the entire financial system. As a consequence, in some circumstances the aggregate risk to the financial system may be much greater than the sum of the risks facing each individual financial institution in the financial system.

During 2009, the Financial Stability Department (FSD) began preparing a database of financial and macroecoonmic data which will enable it to monitor systemic risks to the financial system; risks which may not be evident from the financial returns of individual financial institutions. For example, the FSD will monitor common exposures facing financial institutions (exposures to a specific sector or class of assets) and cyclical trends which could heighten systemic risks, such as rapid credit growth aligned with asset price inflation.

The FSD produced BOU's maiden Financial Stability Report, which provided an assessment of the performance of the financial system as a whole during 2009, and was published in February 2010.

## 5. OTHER ACTIVITIES OF THE SUPERVISION FUNCTION

### Workshops for Board Members of SFIs

BOU organised workshops on Corporate Governance for board members of SFIs. The purpose of the workshops was to strengthen board members' understanding of corporate governance. BOU also prepared and released pamphlets on *Board Responsibilities* that have been circulated to all supervised financial institutions.

### Investigations into illegal activities

BOU conducted ten investigations into unlicensed financial activities in response to complaints from the public. The complaints fell into three main categories; illegal deposit-taking, loss of savings through pyramid schemes and the illegal use of the term 'bank' by unlicensed institutions. Most of the institutions investigated were either registered as Savings and Credit Cooperatives (SACCOs operating under the Cooperatives Act 1992) or as NGO-type microfinance institutions (NGO-MFIs) licensed under the Moneylenders Act 1952.

BOU instructed those using the term '*bank*' illegally (i.e. without a banking license issued by BOU) to immediately stop the practice. It froze the accounts of perpetrators of pyramid schemes and worked closely with the Criminal Investigations Department (CID) of Uganda Police to ensure that suspected fraudsters were apprehended and charged.

### Credit Reference Bureau Services

The year 2009 marked the full scale operationalisation of the Credit Reference Bureau Services (CRBS). The participating institutions (PIs) in the CRBS are all banks, credit institutions and MDIs.

With effect from November 01, 2009, it became mandatory for all borrowers from PIs to obtain a financial card. There are an estimated 530,000 borrowers in all of the PIs. The CRBS aims to issue all of these borrowers with financial cards by June 30, 2011. During 2009, 143,709 financial cards were issued.

### Meetings with the Uganda Bankers' Association

BOU held monthly meetings with the Uganda Banker's Association (UBA), which were chaired by the Governor. The meetings provided a platform for discussing issues of mutual concern, such as the setting up of the Credit Reference Bureau.

## 6. STRENGTHENING CAPACITY FOR SUPERVISION

BOU has an ongoing program of staff training designed to strengthen the skills and knowledge of supervisors. During 2009 all the staff of the Supervision Function attended in-house training programs. Training programs covered banking risks and the preparation of financial statements.

Some members of staff also attended Market Risk and Basel II training organised by the East AFRITAC of the IMF in February 2009. Most of the staff also received training in the basic principles of Islamic banking and finance.

BOU staff attended a wide range of courses during 2009, including courses on new financial products, risk management, prevention of financial crime, improved supervision skills and the harmonisation of supervision methods in the East African region. Staff was also trained in the supervision of mobile banking, microfinance and asset backed securities, risk management, anti-money laundering and fraud control skills.

To build the capacity of BOU's newly established Financial Stability Department, staff attended courses in financial stability analysis, financial statistics, accountancy and stress testing. BOU also supported staff training in IT auditing to build capacity to meet the growing challenges of IT based financial crime.

Staff of the Supervision Function acted as resource persons for training courses held in the region, notably in areas of risk based supervision methodology (where the BOU has been one of the pioneers in the region). This is done both through hosting of staff of other central banks as well as on attachment to central banks within the region.

## 7. REGIONAL COOPERATION

### Monetary Union

The Heads of States of the five partner states of the East African Community (EAC) signed a Protocol for the establishment of the EAC Common Market on 20 November 2009. The Protocol came into effect in July, 2010.

When the protocol comes into effect, the five partner states will remove restrictions on the movement of capital within the EAC belonging to persons who are resident in the EAC. However, restrictions may be retained for reasons pertaining to prudential supervision; public policy considerations; money laundering; and financial sanctions agreed upon by the partner states. A common market within the EAC will require a harmonization of financial sector regulations, to ensure a level playing field for financial institutions in each of the five partner states and to prevent regulatory arbitrage, whereby financial institutions locate in the jurisdiction with the weakest regulation.

### Monetary Affairs Committee

Responsibility within the EAC for the harmonisation of financial regulation and financial sector policies lies with the Monetary Affairs Committee (MAC), which comprises the Governors of the central banks of the partner states. The MAC held its 12$^{th}$ meeting in Kigali, Rwanda on May 7, 2009.

The MAC resolved to strengthen financial sector surveillance, particularly with respect to the off-balance sheet transactions of financial institutions. The MAC also recommended stress testing, monitoring of financial stability indicators and the design of a regional institutional monitoring mechanism to generate early warning indicators of financial distress.

The MAC made recommendations pertaining to supervision to all the five EAC central banks. These recommendations are detailed in Table 3.

**Table 3 MAC Recommendations to Central Banks**

| Recommendation | Action Required |
|---|---|
| Financial Sector Project | Ensure the study by IMF on Financial Sector Project incorporates an evaluation of the structure and regulatory framework of the financial sector in the EAC region |
| Risk Based Supervision (RBS) methodology | Publish their RBS methodologies in line with international trends towards supervisory transparency |
| Regulation of MFIs | Harmonise regulation of microfinance institutions. |
| CRBS | Finalise establishment of credit reference systems in their respective countries by December 2010 |
| Capital charge for market risk | Complete implementation of the capital charge for market risk by December 2010 |
| BCPs | Conduct peer/self assessment of their compliance with the revised Business Continuity Plans by December 2010 |
| Joint Inspections | Continue joint inspections, including the pre-planning phase to cover the whole scope of the inspection |
| BCMP Tests | Focus Onsite surveillance on testing of institutional Business Continuity Management plans |
| BCM guidelines | Urge other domestic financial sector regulators to develop and issue BCM guidelines to the institutions under their purview |
| Incidental Financial Services | Review their policy positions on banks offering of incidental financial services in view of customer trends and the need to deepen the financial sector |

The MAC has developed a program to harmonize bank supervision methodologies across the EAC region. Under this program, supervisors from each of the central banks in the EAC participate in on-site examinations carried out by their counterparts in other EAC partner states. During 2009, eight BOU officers participated in on-site examinations conducted by the central banks of Kenya and Tanzania.

## 8. ACTIVITIES PLANNED FOR 2010

### Legislative Framework

BOU intends to prepare amendments to the FIA, 2004, for submission to Cabinet and then Parliament. The amendments will include provisions to allow SFIs to provide Islamic banking and financial products and to allow banks to engage in Bancassurance. In 2010, the BOU will review the MDI Act, 2003 and will also continue supporting the Ministry of Finance, Planning and Economic Development to develop a regulatory framework for *Tier 4* microfinance institutions. The review of the MDI Act 2003 will be a consultative process in which the stakeholders in the microfinance industry will be consulted.

### Financial Literacy and Financial Consumer Protection

Public access to information on the financial sector plays an important role in helping to protect the public from fraudulent financial activity as well as improving access to financial services. A recent survey conducted by BOU and GTZ revealed that SFIs do not provide adequate information for customers to make informed decisions.

Moreover, because of the low level of financial literacy among the public, some people are vulnerable to fraudulent money making schemes.

BOU plans to cooperate with the Education Ministry to have classes on financial literacy incorporated into the school curriculum. Efforts are also underway to design a framework for financial consumer protection. Financial service providers will be required to address consumer complaints fairly. BoU and GTZ are in the process of designing a mechanism which is intended to resolve complaints made by customers.

## Home Host Relationships

BOU intends to sign Memoranda of Understanding (MoU) with the regulators of all foreign banks with subsidiaries in Uganda. BOU intends to sign a MoU with the Reserve Bank of South Africa which is the home regulator of Stanbic Bank. The BoU has a memorandum of understanding with the countries in the East African Community, which enables it to share information on Equity Bank, KCB, Diamond Trust Bank, Fina Bank, and ABC Capital Bank, each of which is a subsidiary of a bank headquartered in another partner state of the EAC.

In consultation with the home regulators, BOU is also seeking to establish a formal home/host relationships to cater for the following banks; United Bank for Africa (Nigeria), Standard Chartered and Barclays Bank (United Kingdom), Bank of Baroda (India) and Citibank (United States of America).

## Automation of Returns

Due to the rapidly growing number of licensed FXB and MR operators, as well as the need to closely monitor forex inflows and outflows, a pilot automation of returns will be undertaken between February and April 2010. All operators will thereafter be required to automate and submit their statutory returns in electronic format.

## APPENDIX 1: SELECTED FINANCIAL SOUNDNESS INDICATORS FOR UGANDA'S BANKING SYSTEM (*percent*)

| | Mar-08 | Jun-08 | Sep-08 | Dec-08 | Mar-09 | Jun-09 | Sep-09 | Dec-09 |
|---|---|---|---|---|---|---|---|---|
| **Capital Adequacy** | | | | | | | | |
| Regulatory capital to risk-weighted assets | 21.07 | 20.46 | 19.61 | 20.74 | 22.04 | 21.13 | 21.82 | 20.95 |
| Regulatory tier 1 capital to risk-weighted assets | 19.83 | 19.11 | 18.19 | 18.73 | 20.18 | 19.29 | 19.38 | 18.67 |
| Total capital to total assets | 11.53 | 11.75 | 12.1 | 13.07 | 13.84 | 13.42 | 13.63 | 13.41 |
| **Asset quality** | | | | | | | | |
| NPLs to total gross loans | 3.94 | 4.09 | 3.68 | 2.2 | 3.06 | 4.03 | 4.13 | 4.2 |
| NPLs to total deposits | 2.49 | 2.73 | 2.76 | 1.59 | 2.18 | 2.79 | 2.9 | 3.01 |
| Sectoral distribution of loans | | | | | | | | |
| Agriculture | 9.07 | 6.03 | 5.71 | 6.93 | 5.38 | 4.5 | 5.49 | 5.17 |
| Mining and quarrying | 0.37 | 0.35 | 0.57 | 0.83 | 0.39 | 0.3 | 0.4 | 0.24 |
| Manufacturing | 14.04 | 12.37 | 13.45 | 14.2 | 15.07 | 15.17 | 13.33 | 12.81 |
| Trade | 13.42 | 12.24 | 14.72 | 18.2 | 19.88 | 20.62 | 19.76 | 21.66 |
| Transport and communication | 7.96 | 6.89 | 5.54 | 6.21 | 6.16 | 5.81 | 5.88 | 7.42 |
| Electricity and Water | 1.24 | 0.85 | 0.76 | 0.74 | 0.68 | 0.63 | 0.76 | 0.65 |
| Construction | 10.25 | 9.72 | 11.1 | 10.94 | 10.81 | 11.45 | 10.13 | 9.92 |
| Personal loans | 17.64 | 15.4 | 25.79 | 25.73 | 21.26 | 21.93 | 26.22 | 23.41 |
| Others | 26.03 | 36.15 | 22.35 | 16.21 | 20.37 | 19.6 | 18.03 | 18.72 |
| Large exposures to total capital | 121.96 | 118.67 | 120.53 | 106.93 | 92.5 | 99.16 | 93.25 | 111.22 |
| **Earnings & profitability** | | | | | | | | |
| Return on assets | 3.29 | 3.43 | 3.13 | 4.04 | 4.25 | 3.17 | 2.36 | 2.02 |
| Return on equity | 25.23 | 25.65 | 23.15 | 27.72 | 27.34 | 20.34 | 15.23 | 12.69 |
| Net interest margin | 10.35 | 9.74 | 10.43 | 11.31 | 11.27 | 10.67 | 10.09 | 10.17 |
| Cost of deposits | 3.25 | 3.03 | 3.05 | 2.49 | 3.28 | 3.32 | 4.02 | 3.87 |
| Cost to income | 70.69 | 69.38 | 73.76 | 65.79 | 64.68 | 74.34 | 79.76 | 82.23 |
| Overhead to income | 46.71 | 49.03 | 48.93 | 49.5 | 47.25 | 51.93 | 53.16 | 56.51 |
| **Liquidity** | | | | | | | | |
| Liquid assets to total deposits | 50.8 | 48.22 | 43.84 | 48.09 | 42.27 | 42.17 | 43.63 | 44.67 |
| Total loans to total deposits | 63.34 | 66.55 | 75.18 | 72.51 | 71.32 | 69.14 | 70.39 | 71.73 |
| **Market Sensitivity** | | | | | | | | |
| Foreign currency exposure to regulatory tier 1 capital | -9.71 | -7.93 | -10.74 | -1.42 | -1.49 | -2.93 | -0.93 | -0.7 |
| Foreign currency loans to foreign currency deposits | 58.39 | 56.82 | 68.77 | 65.51 | 57.53 | 57.29 | 53.26 | 57.85 |
| Foreign currency assets to foreign currency liabilities | 105.77 | 96.44 | 90.53 | 102.72 | 98.41 | 109.77 | 108.72 | 106.96 |