BANK OF UGANDA

37/45 KAMPALA ROAD, P.O. BOX 7120, KAMPALA
Telephone: 256-414-258441/6, 258061, 0312 392000, 0417 302000. Telex: 61069/61344;
Fax: 256-414-233818, Web site: www.bou.or.ug, email address: info@bou.or.ug

Financial Stability Review

Quarter ended 30th June 2019

The resilience of the Uganda financial sector to risks remained strong over the quarter ended June 2019, supported by better domestic economic growth prospects. Domestic financing conditions continued to improve on the back of the sustained accommodative monetary policy stance and strengthening of the Uganda shilling. The banking industry has capital and liquidity buffers well above the minimum requirements, reinforcing resilience to shocks. Going forward, banks should remain vigilant and continue to take measures to address emerging domestic and global macro-financial risks.

1. The Macro-financial Environment

Global

During the quarter ended June 2019, global economic growth remained subdued, largely on account of persisting trade policy tensions, Brexit-related uncertainty, and geo-political tensions. The IMF forecasts global output to expand by just 3.2 percent in 2019 and 3.5 percent in 2020, a slowdown compared to 3.6 percent growth in 2018[1]. This could affect Uganda's external position, with potential risks to the financial system in form of foreign exchange rate risk and diminished earning capacity to fulfil loan obligations.

The risks from continued shift in expectations over the monetary policy path of the US and possible escalation of global trade tensions, which were highlighted in our previous report, have continued and could increase financial market volatility with pass through into domestic financial conditions, going forward.

[1]International Monetary Fund: *World Economic Outlook Report, July 2019.*

Domestic

Uganda's economy grew by 6.1 percent in 2018/19 and it is forecast to grow by 6.0 – 6.3 percent in FY2019/20. This is expected to further support banks' balance sheets growth, with credit extension.

Domestic financial conditions remained stable. While core inflation increased gradually from 0.8 percent in June 2018 to 4.9 percent in June 2019, it remained within the policy target, motivating the sustained accommodative monetary policy stance. With the key policy rate, the Central Bank Rate (CBR), kept at 10 percent since October 2018, banks' lending rates remained stable, promoting lending to the private sector and further improvement in asset quality. Also, the strengthening of the Uganda Shilling against the U.S. Dollar over the year ended June 2019 to close at USh.3,694.8/$, somewhat eased banks' credit risk associated with foreign currency lending.

However, the growing exposure of banks to government debt remains a concern, with potential implications for financial stability. The stock of domestic debt remains high and increased faster, by 18.2 percent, compared to gross private sector credit, which grew by 13.0 percent, in the year to June 2019.[2]

2. Banking Industry Performance

Total Assets, Deposits and Shareholders funds: Over the year ended June 2019, the banking industry total assets increased by 10.5 percent, to USh.30.3 trillion, largely driven by growth in private sector lending and investment in government securities. Gross loans and advances increased by 11.2 percent, to USh.13.6 trillion as at end June 2019. Notably, the proportion of foreign currency denominated loans to total loans reduced from 38.1 percent to 36.4 percent over the year, easing banks' exposure to foreign exchange rate risk. Also, banks' investment in government securities increased by 14.7 percent, to USh.6.6 trillion over the year.

The assets are largely funded by retail deposits, which grew by 8.8 percent to USh.21.0 trillion over the year ended June 2019. Concurrently, total shareholders' funds increased by 10.1 percent (Ushs.504.0 billion), further cushioning the banks' exposure.

Lending: The growth in gross loans, over the year ended June 2019, cut across most sectors, with manufacturing registering the highest growth of 20.5 percent. The building, construction and real estate sector, trade & commerce sector, and the Personal loans sector continued to account for more than 50 percent of total loans, similar to June 2018. Particularly, loans to the building, construction and real estate sector, which prominently underpins banks' lending grew by 11.0 percent in the year to June 2018), amidst relatively stable real estate prices. Risks from property prices remained subdued as the Residential Property Price Index (RPPI) shows that over the year ended June 2019, property prices grew by 2.5 percent within Greater Kampala Metropolitan Area, compared to 5.3 percent registered during FY2017/2018.[3]

Asset quality: Asset quality, as measured by the ratio of non-performing loans to total gross loans and advances (NPL ratio), continued to improve, with the aggregate industry NPL ratio improving to 3.8 percent as at end June 2019, from 4.4 percent as at end June 2018. The improvement was driven by a 5.2 percent reduction in non-performing loans, from USh.542.84 billion as at end June 2018 to USh.514.9 billion as at end June 2019. Moreover, the NPL ratio attributed to foreign currency denominated loans reduced from 4.6 percent to 2.8 percent over the same period.

Earnings and profitability: The banking sector registered an aggregate net-after-tax profit of USh.776.7 billion for the year ended June 2019, an improvement compared to USh.738.7 billion earned during the prior year, ended June 2018. This was largely on account of increase in interest income, by USh.217.0 billion. Aggregate return on assets (ROA) & return on equity (ROE) declined from 2.8 percent and 16.7 percent (for the year ended June 2018) to 2.7 percent and 15.9 percent (for the year ended June 2019), respectively during the year. The decline in profitability ratios was due to the faster growth in total shareholders' funds and total assets (denominators for the ratios), which outpaced the increase in profit. A few small banks registered losses in the year to June 2019.[4]

Capital adequacy: The banking industry was also adequately capitalized, with the increase in profit and share premium fostering growth in aggregate core capital and total capital, by 11.5 percent and 10.2 percent, respectively in the year to June 2019. On the contrary, total risk weighted assets

---

[2] *Refer to the Monthly Macroeconomic Indicators:* *https://www.bou.or.ug/bou/rates_statistics/statistics.html*

[3] *Uganda Bureau of Statistics: Residential Property Price Index reports.*

[4] *For purposes of this report, a bank has been designated as small if its total assets account for less than 3.0 percent of the banking industry total assets, as at 30th June 2019.*

increased by 8.4 percent over the same period. Consequently, the aggregate capital adequacy ratios – core capital-to-risk weighted assets and total capital-to-risk weighted assets – stood at 20.3 percent and 22.1 percent, well above the minimum capital adequacy requirements of 10 percent and 12 percent, respectively.

Liquidity: In the year to June 2019, the sector held sufficient liquidity buffers. The industry Liquid assets–to–deposits ratio was 45.5 percent, well above the minimum requirement of 20 percent, but slightly lower than 46.6 percent ratio held in the previous year. The liquidity coverage ratio (LCR)[5] showed that all banks, but one, held sufficient high quality liquid assets to meet any sudden demand for liquidity over a 30-day stress scenario for all currencies.

Resilience of the Banking System: Quarterly Stress tests conducted on the banking sector at the end of June 2019 showed that on aggregate, most banks, notably including all four domestic systemically important banks (DSIBs), had sufficient capital and liquidity buffers to absorb plausible shocks to the system. The credit risk stress test revealed that the least resilient bank (a small bank) would be affected when 3.6 percent of its performing loans become non-performing; an improvement compared to the assessment in June 2018. Regarding liquidity risk, a simulated bank run stress test scenario of a sudden withdrawal of short-term deposits, indicated that liquidity buffers of six banks would be depleted by day five of a bank run; while other banks were able to endure this shock.

Composite Indicators off Aggregate Risk: In line with international best practice, BOU computes two aggregate indicators of systemic risk, which provide an overall picture of risk stance. The first is the *risk dashboard*, which summarises the main risks and vulnerabilities to Uganda's banking system, indicates that overall risk to the banking system remained moderate, though rising exposure to government borrowing raised overall risk marginally. The second is the *aggregate banking sector resilience index*, which covers a range of financial soundness indicators, indicated improved resilience to systemic shocks, fostered by continued improvement in asset quality and increase in capital buffers.

3. Key Regulatory Developments

In a bid to strengthen risk assessment, the Financial Stability Committee (FSC) approved that BOU should implement bottom up stress testing. This will require all banks to run stress tests using a common scenario of risks provided by BOU and will be rolled out starting October 2019.

4. Outlook for Financial Stability

As mentioned in the previous *report*, the outlook is for overall macro-financial risks to financial stability to remain moderate in 2019. On the domestic front, a key concern is the projected gradual rise in domestic inflation[6], however, the pick-up in economic growth prospects is likely to support financial stability. Externally, trade tensions and volatile financial markets could affect the domestic trade sector, exert depreciation pressures on the domestic currency and affect bank resilience.

[5] *LCR is a Basel III measure that requires banks to hold sufficient high quality liquid assets over a 30-day period.*

[6] *Bank of Uganda Monetary Policy Statement, August 2019.*