

BANK OF UGANDA



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Financial Stability Review

Quarter ended 31st March 2019

Uganda's financial system stability improved over the quarter ended March 2019. Domestic financing conditions improved, in spite of tightened global financial conditions that threatened most of the emerging markets and developing economies. The Central Bank Rate (CBR) was maintained at 10.0 percent during March 2019, and this echoed through the range of interest rates. Overall, banking sector resilience improved relative to March 2018. Expectations are for continued, but prudent, growth in credit, cognizant of macroeconomic developments and outlook. Further, the enhanced regulatory framework is expected to strengthen financial stability in Uganda.

1. The Macro-financial Environment

1.1. Global¹

Global economic growth has weakened due to heightened trade tensions between the US & China, episodes of financial stress & volatility. Global growth softened to 3.6 percent in 2018, and is projected to decline further to 3.3 percent in 2019.

However, a pickup is expected in the second half of the year, supported by significant policy accommodation by major economies. Global financial conditions generally remain accommodative across both developed & developing nations.

Looking ahead, possible triggers like shifting expectations over the monetary policy path of the US, escalation of trade tensions and heightened

financial market volatility could cause tightening in financial conditions.

1.2. Domestic

In spite of the tightened global financial conditions, Uganda's economy continued its recovery, growing by 6.2 percent in 2017/18 and it is forecast to grow marginally by 6.3 percent in 2019. This growth has been supported by accommodative monetary policy, favorable weather conditions, FDI and public investment in oil-related infrastructure.

With the key policy rate – the Central Bank Rate (CBR) – maintained at 10.0 percent in March 2019, inflation was 3.0 percent, well below the medium term target rate of 5.0 percent during that month. However, projections are for inflation to gradually rise during 2019.

Commercial banks' weighted average deposit rates on both shilling and foreign currency deposits increased marginally. However, lending

¹International Monetary Fund: *Global Financial Stability Report, April 2019*; *World Economic Outlook, April 2019*.

rates on shilling loans dropped as lending rates on foreign currency loans picked up.

2. Banking Industry Performance

Total Assets and Lending: Banks' total assets increased by 9.9 percent annually, to US\$26 trillion at the end of March 2019. This growth largely reflected banks' increased holdings of Government securities and upsurge in loans & advances. Banks' investment in government securities rose by 29.5 percent while loans grew by 11.8 percent (7.9 percent in March 2018). Notably, the proportion of foreign currency denominated loans to total loans reduced to 37.7 percent in March 2018, from 40.3 percent in the previous year. This shows reduced exposure of banks' balance sheets to foreign exchange risk.

Sectoral Lending: Most sectors registered increased lending during the year, with manufacturing registering the highest growth of 23.4 percent. The building, construction & real estate sector, which accounts for the largest share of banks' credit (20.3 percent at the end of March 2019), registered annual growth of 10.1 percent in March 2019. This was faster than the 7.5 percent annual growth in March 2018. Increased lending to the sector can be attributed to the recovery in property prices during the second half of 2018. As such, the Residential Property Price Index (RPPI) for GKMA registered a growth of 9.4 percent for the year ending March 2019 (third quarter 2018/19) compared 7.1 percent registered for the year ended December 2018.²

Asset quality: Asset quality, as measured by the ratio of non-performing loans to total gross loans and advances (NPL ratio) improved to 3.8 percent, from 5.3 percent recorded in March 2018. The improvement in asset quality was largely attributed to the significant reduction in the industry stock of non-performing loans from US\$618.7 billion to US\$498.4 billion during the period under review. Consistent with banks'

reduction in exposure to foreign currency denominated loans, the proportion of foreign currency denominated NPLs relative to total NPLs reduced from 43.5 percent to 26.6 percent between March 2018 and March 2019.

Earnings and profitability: The improvement in asset quality translated into reduction in provisions for bad debts and increased profitability of the sector. Aggregate net after tax profit increased from US\$658.9 billion in March 2018 to US\$772.2 billion in March 2019. In addition, a less than proportionate increase in shareholder funds and total assets resulted in a rise in profitability ratios. The average return on equity (ROE) and return on assets (ROA) were 15.9 percent and 2.8 percent, respectively. However, some small banks³, registered losses in the year to March 2019.

Capital adequacy: The banking industry maintained adequate capital buffers during March 2019. The aggregate industry tier 1 capital adequacy ratio (CAR) & total CAR were 20.4 percent & 22.3 percent respectively, well above the minimum requirement of 10 percent for tier 1 CAR and 12 percent for total capital CAR. However, this was a marginal reduction from the capital ratios held at the end March 2018. This was largely attributed to faster growth in credit which translated into an increase in the Risk Weighted Assets by 16.5 percent, while tier 1 capital & total capital increased by 10.4 percent & 8.8 percent respectively in the year to March 2019.

Liquidity: In the year to March 2019, the sector held sufficient liquidity buffers. The industry Liquid assets-to-deposits ratio was 44.1 percent, well above the minimum requirement of 20 percent, but lower than 52.9 percent ratio held in the previous year. The reduction in the liquidity ratio reflects banks' shift in asset allocation to longer term government securities. The Liquidity

² Uganda Bureau of Statistics: Residential Property Price Index reports.

³ 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.

coverage ratio (LCR)⁴ showed that 22 banks held sufficient high quality liquid assets (HQLA) to sustain them through a 30-day stress scenario on a consolidated basis.

Resilience of the Banking System: Stress tests conducted on the banking sector showed that on aggregate, most banks, especially the DSIBs, have sufficient capital and liquidity buffers that provide resilience to credit and liquidity risks. A credit risk stress test for deterioration in performing loans indicated that the least resilient bank (a small bank) would be affected when 1.3 percent of its performing loans become non-performing. For liquidity risk, a simulated bank run stress test – entailing sudden withdrawal of short-term deposits – indicated that liquidity buffers of six banks, albeit small banks, would be depleted by day five of a bank run.

This notwithstanding, the sector’s resilience index, which assesses and consolidates a wider array of the banking sector financial soundness indicators, showed a slight decline in resilience compared to the previous quarter. In addition, the BOU risk dashboard, which summarises the main risks and vulnerabilities in the Ugandan banking system, found that the overall risk to the sector was subdued, marginally edging upwards from 0.43 percent to 0.47 percent.

3. Key Regulatory Developments

The Financial Institutions (Capital Adequacy Requirements) Regulation, 2018 took effect in September 2018. The regulation enhanced the capital requirements for financial institutions, in order to improve resilience to market and operational risks, and financial institutions are now required to hold additional capital as a cushion for market risk. The minimum on-going tier 1 capital/RWA requirement was increased to 10.0 percent.

4. Outlook for Financial Stability

In 2019, domestic macro-financial risks to financial stability are likely to remain moderate, in comparison to 2018. From the external sector, slower than expected global economic growth, tightening global financing conditions and subdued commodity prices could diminish foreign income as well as exert depreciation pressures on the Uganda Shilling, and adversely affect financial stability.

⁴ LCR is a Basel III measure that requires banks to hold sufficient high quality liquid assets over a 30-day period.