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 September 2019

The resilience of the financial sector to risks improved through the quarter ended September 2019. Domestic financing conditions continued to improve, with the exchange rate remaining relatively stable while the key policy interest rate, the Central Bank rate, was reduced further to 9.0 percent. The banking industry's capital and liquidity buffers remain well above the minimum requirements, reinforcing resilience to shocks. Going forward, emerging domestic and global macro-financial risks are the key concern for financial stability.

1. The Macro-financial Environment

Global

Through the quarter ended September 2019, persisting trade disputes and growing investor concerns continued to weigh down on global economic prospects. The International Monetary Fund (IMF) revised its forecast of global output growth down to 3.0 percent for 2019, a reduction of 0.2 percentage points from its July 2019 projection; and its lowest level since 2008–09.[1] Notably, global manufacturing weakened which could affect Uganda's external position as a primary commodities exporter, and consequently lessen borrowers' capacity to meet loan obligations.

To partly counterbalance slower growth, many advanced and emerging market economies have shifted towards increased monetary policy accommodation. However, this is encouraging financial risk-taking and fueling a buildup of vulnerabilities in the global financial system, including an increase in holdings of riskier and more illiquid assets by institutional investors; rising corporate debt burdens; and greater reliance on external borrowing by emerging and frontier market economies.[2] Uganda's financial stability could be affected by subsequent unfavorable reversal in financial conditions.

Domestic

While Uganda's gross domestic product (GDP) was forecast to grow by 6.0 percent for the FY2019/20, indications show that economic activity slackened in the first half of 2019. This could undermine credit growth and asset quality.

Domestic financial conditions have remained stable. Inflation remains subdued; with core inflation reducing to 2.6 percent (October 2019) from 3.5 percent (October 2018). The key policy rate, the Central Bank Rate (CBR) was reduced to 9.0 percent in October 2019. This, coupled with the sustained relative stability and strengthening of the Uganda Shilling against the U.S. Dollar, could support bank lending and improve loan repayment going forward.

The recent rebasing of Uganda's GDP, has reduced the proportion of total government debt to nominal

[1] IMF: *World Economic Outlook Report, October 2019.*

[2] IMF: Global Financial Stability Report, *October 2019.*

GDP to 36.7 percent, from 43.8 percent (prior to rebasing) in June 2019. Nevertheless, the upward trend in government borrowing could increase market and roll-over risk for banks, as they invest more in government debt.[3]

2. Banking Industry Performance

Total Assets, Deposits and Shareholders funds[4]: Total assets of the banking industry increased by 2.3 percent, to USh.31.0 trillion, over the quarter ended September 2019; largely attributed to growth in private sector lending and investment in the Bank of Uganda (BOU) deposit facility. Banks' investment in the BOU deposit facility grew by 39.6 percent (USh.243.8 billion) to USh.2.1 trillion over the quarter, as holdings of government securities reduced marginally 0.7 percent to 6.6 trillion. Gross loans and advances increased by 1.8 percent (USh.243.8 billion) to USh.13.8 trillion, though this was slower than the 4.1 percent growth over the prior quarter, to June 2019. Notably, the proportion of foreign currency denominated loans to total loans reduced from 36.4 percent to 36.3 percent over the quarter, further easing banks' exposure to foreign exchange rate risk.

On the funding side, the industry continues to rely largely on stable funding sources, retail deposits, which grew by 2.7 percent to USh.21.6 trillion over the quarter constituted 84.1 percent of total liabilities as at end September 2019. Total shareholders' funds increased by 3.6 percent, to USh.5.3 trillion; over the same period

Sectoral lending: The building, construction and real estate sector still accounts for the largest share of total bank loans at 21 percent. Other sectors; trade, personal loans, manufacturing, and agriculture account for 18.5 percent, 18.9 percent, 13.5 percent, and 13.4 percent, respectively, of total loans.

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

[4] *Year-on-year, total assets, customer deposits, and total shareholders' funds rose by 13.6 percent, 13.5 percent, and 10.6 percent, respectively, over the year ended September 2019.*

In terms of loan growth, the agriculture sector registered the highest growth, of 8.0 percent, over the quarter ended September 2019, mainly for agro-processing and production. Building, construction and real estate sector loans increased by 6.5 percent, largely driven by construction and mortgages. The Residential Property Price Index (RPPI), a key indicator of property prices, shows that over the quarter ended September 2019, residential property prices grew by 6.2 percent within Greater Kampala Metropolitan Area, compared to a 0.3 percent decrease recorded in the prior quarter ended June 2019.[5]

Asset quality: The aggregate industry asset quality, as measured by the ratio of non-performing loans to gross loans and advances (NPL ratio), deteriorated to 4.4 percent from 3.8 percent, over the quarter under review; although this was an improvement over the year compared to the NPL ratio of 4.7 percent as at end September 2018. The development during the quarter was attributed to a greater increase in the stock of NPLs, in spite of the registered increase in gross loans and advances.

However, while foreign currency denominated loans account for 36.3 percent of total lending, the proportion of NPLs attributed to foreign currency denominated loans, relative to the total stock of NPLs, remains low, at 30.1 percent, as at end of the quarter.

Earnings and profitability: The banking sector profitability improved, registering an aggregate net-after-tax profit of USh.231.6 billion for the quarter ended September 2019, compared to USh.214.4 billion earned during the prior quarter (ended June 2019). Consequently, the industry's aggregate return on assets (ROA) and return on equity (ROE) improved to 2.81 percent and 16.1 percent, for the 12-months period ended September 2019, compared to 2.69 percent and 15.83 percent for the 12-months period ended June 2019, respectively. A few small

[5] *Uganda Bureau of Statistics: Residential Property Price Index report (September 2019).*

banks were loss-making during the quarter ended September 2019.[6]

Capital adequacy: The aggregate banking industry Core Capital (CC) and Total Capital (TC) improved by 1.6 percent and 1.5 percent, respectively, over the quarter under review, enhancing resilience to risk exposure. With the risk-weighted assets (RWA) having increased by 1.5 percent, over the same period, the capital adequacy ratios, CC/RWA and TC/RWA, were largely unchanged compared to the June 2019 position, and stood at 20.3 percent and 22.1 percent, respectively, as at end September 2019. All banks, but one, were well above the minimum capital adequacy requirements of 10 percent and 12 percent, for CC/RWA and TC/RWA, respectively.

Liquidity: The banking industry held sufficient liquidity buffers; with the aggregate industry liquid assets–to–deposits ratio improving from 45.5 percent to 50.3 percent, over the quarter under review. Individually, all banks were above the regulatory minimum requirement of 20 percent. In addition, the liquidity coverage ratio (LCR)[7] results indicated that all banks 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 September 2019 showed that on aggregate, most banks, including all four domestic systemically important banks (DSIBs), had sufficient capital and liquidity buffers to absorb plausible shocks to the system. The liquidity risk stress test, entailing a simulated bank run scenario of a sudden withdrawal of short-term deposits, indicated that five banks' liquidity buffers would be depleted by day five of a bank run, while other banks were able to endure this shock. This represented an improvement, as a similar test in the prior quarter indicated that six banks would be affected. However, the credit risk stress test revealed that the least resilient bank (a small bank) would be affected when 3.1 percent of its performing loans become non-performing, a deterioration relative to the assessment of June 2019.

Composite Indicators off Aggregate Risk: BOU computes two aggregate indicators of systemic risk, which provide an overall assessment of the risk prospects. The first, the *risk dashboard*, summarizes the main risks and vulnerabilities to Uganda's banking system. The end-September 2019 metrics indicate that overall risk to the banking system remained low, but increased marginally mainly on account of macro factors including the slowdown in domestic economic activity, potential risks from a slowdown in global growth and rising sectoral concentration of bank lending. However, the second indicator, *the banking sector resilience index*, which consolidates a range of financial soundness indicators, shows that the banking sector's resilience to the above potential risks improved, boosted by the increase in capital and liquidity buffers.

3. Outlook for Financial Stability

The outlook is for overall macro-financial risks to financial stability to remain moderate. However, the downside risks to this outlook include any intensification of the slowdown in both domestic and global economic activity including trade, which would affect borrowers' capacity to meet loan obligations. Furthermore, a reversal of global financing conditions could lead to higher capital outflows, exchange rate volatility and increased government debt costs which would adversely affect domestic financial stability.

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[6] *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 September 2019.*

[7] *LCR is a Basel III measure that requires banks to hold sufficient high quality liquid assets, of at least 100.0 percent of net outflows, over a 30-day stress period.*