Bank of Uganda

FINANCIAL STABILITY REPORT

December 2009| Issue No. 1

Finalised with data available by 30 November 2009

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Foreword

The global financial crisis, which came to a head in 2008, was first and foremost a systemic financial crisis. Systemic financial crises have the potential to cause immense damage to the economy, as was vividly illustrated when the financial crisis triggered the deepest global recession since before the Second World War. An important lesson of the global financial crisis is that the financial system can become vulnerable to a systemic crisis even though the macroeconomy is stable and major financial institutions within the system are able to comply with all prudential regulatory requirements.

The crucial policy lesson to be drawn from the global crisis is the imperative for the authorities responsible for financial stability to strengthen their analysis and surveillance of systemic risks to the financial system and to devise policy instruments which can mitigate these risks. Accordingly, the Bank of Uganda (BoU) has established the *Financial Stability Department (FSD)*, the primary function of which is to monitor and analyse systemic risks to the Ugandan financial system. The FSD will work closely with other BoU officials, notably the supervisors of commercial banks and non bank financial institutions, with those responsible for macroeconomic analysis and for the payments system. The *FSD* will also collaborate with the agencies responsible for regulation of the capital markets (Capital Markets Authority) and insurance companies (Insurance Commission).

The *FSD* will prepare a bi-annual *Financial Stability Report (FSR)*, of which this is the inaugural volume and which will be made public. The *FSR* will provide an objective analysis of the current state of the financial system and its vulnerability to systemic risk. It will highlight potential sources of vulnerability in the short to medium term. The objective of the *FSR* is to contribute to the understanding of financial system vulnerabilities among policymakers, financial market participants and the general public. A better public awareness of financial system vulnerabilities may itself serve to encourage financial institutions to curb activities which might exacerbate systemic risks and will also help to promote awareness of the need for policy reforms to strengthen the resilience of the financial sector.

Emmanuel Tumusiime Mutebile

GOVERNOR

Summary

The global financial crisis which erupted in 2008 drove many industrialized and emerging market economies into recession. Governments in several major industrialized countries were forced to implement unprecedented measures to restore public confidence in financial institutions, restore liquidity to the financial system and boost aggregate demand. These measures are now yielding some success, with the global economy having started to recover in 2009.

The Ugandan financial system has shown resilience in the face of the turmoil in global financial markets. This is largely because financial institutions in Uganda had few direct exposures to distressed financial institutions or toxic assets abroad. Ugandan banks had no recorded asset exposure to the US sub-prime mortgage market. Most banks in Uganda remained sound, including the subsidiaries of foreign-owned banks which were affected severely by the crisis in their home countries. In addition, overseas debt markets are not an important source of bank funds. The banking sector remained profitable and solvent with regulatory capital averaging 22 percent of risk weighted assets in the third quarter of 2009.

Nevertheless, the global crisis did have an impact on both the macroeconomy and financial markets in Uganda. A weakening of the current account of the balance of payments and the exit of foreign portfolio investors from the local debt and equity markets led to a sharp depreciation of the exchange rate. The outflow of foreign portfolio capital also caused tight liquidity conditions and greater volatility in the interbank market in the period after October 2008. During 2009 there was a deceleration in the growth of bank lending to businesses and households and a small rise in non-performing loans.

In the face of these developments, the Bank of Uganda took several actions to provide liquidity to the banking sector. First, the BoU intervened in the foreign exchange market, selling US$235 million on a net basis in the 2008/09 fiscal year, to slow the sharp depreciation of the exchange rate. Secondly, in March 2009, the BoU reduced the margin within the rediscount rate, which is the reference rate for the Bank rate, from 6.7 percent to 3.4 percent and further downward to 3 percent in September 2009, thereby reducing the cost of access to the BoU's rediscount and Lombard facilities.

Section I of this report introduces the concept of financial stability analysis and systemic risk. It presents a brief discussion of the distinction between macroprudential and microprudential regulation. It also outlines the role of the BoU in ensuring financial stability and producing the bi-annual *Financial Stability Report*. The major purpose of the *Financial Stability Report* is to assess the vulnerabilities of the financial system to systemic risk and to evaluate the systemic soundness of the financial sector.

Section II highlights recent developments in the advanced economies, emerging markets and the East African region. This section contains a discussion of the developments in advanced and emerging market economies that may affect financial stability in Uganda. Developments in the East African region are also analysed.

Section III focuses on developments in the Ugandan economy and financial markets.

Section IV discusses the performance of Uganda's financial institutions. The emphasis is on the banking sector because the potential systemic risks to the financial system mainly originate from this sector.

1. Introduction to Financial Stability Analysis

1.1. Overview

The recent global financial crisis and the reforms suggested by global leaders[1] to avert future systemic crises have raised the public profile of financial stability analysis. There is a growing recognition of the importance of macroprudential analysis and regulation to reduce systemic risk as a complementary policy framework to microprudential regulation and macroeconomic management.

Systemic risk

The terms systemic risk and macroprudential risk are often used interchangeably and are essentially synonymous: the vulnerability of the financial system to a systemic crisis. A systemic crisis involves the failure of major financial institutions or a number of financial institutions, which together comprise a major part of the financial system, as a consequence of which key functions of the financial system such as the payment system and the extension of credit are impaired, which can have significant costs for the real economy.

Crucial to this concept of systemic risk is that it is possible for risks to build up and threaten the systemic stability of the financial system even though each individual financial institution is complying with the relevant prudential regulations. Hence the normal type of microprudential regulation and supervision that focuses on individual institutions and their compliance with regulatory requirements may not be sufficient to prevent systemic risks from building up in the financial system.

[1] G20 Leaders' Statement, The Pittsburg Summit, September 24-25 2009

Systemic risk can be conceptualised in two dimensions: a cross sectional dimension and a time dimension. The cross sectional dimension arises because different financial institutions within the financial system may have common exposures to risk that could result in the joint failures of these institutions. Such common exposures could arise from intermediation between institutions, such as interbank borrowing or counterparty risk. They could also arise because the asset portfolios of individual institutions share common exposure to a specific sector (for example real estate).

At the system-wide level, each individual financial institution does not pose an identical threat to systemic stability: some are much more important than others, and although size matters it is not the only factor used to determine whether or not a financial institution is systemically important. While most systemically important financial institutions are large commercial banks, they may also include some non-bank financial institutions. In addition, a financial institution that is systemically important in one period may not necessary be in the subsequent periods. Macroprudential monitoring encompasses all systemically important financial institutions.

The second dimension of systemic risk is the time dimension. The build up of systemic risks and subsequent realisation of losses often follows a procyclical sequence, which has self-reinforcing effects. Risks build up during economic booms, when typical features are rapid credit growth, asset price bubbles, increased competition in financial markets, and in some cases macroeconomic imbalances; these risks are often masked by the good performance of the economy. These vulnerabilities can materialise into system-wide losses when asset prices fall or because of some other trigger, such as a downturn in the economy or a BOP crisis.

1.2. Defining Financial Stability

A stable financial system is one in which financial institutions carry out their normal function of intermediating funds between savers and investors and facilitating payments. By extension, financial instability is a material disruption to the intermediation and payments processes, which has damaging consequences for the real economy. Ensuring financial stability is a forward looking exercise which seeks to identify vulnerabilities and take actions to prevent systemic instability. However, while it is possible to define financial stability, there is as yet no unequivocal measure of financial stability, in contrast with price stability where many central banks have clearly defined targets.

How does systemic stability analysis differ from microprudential supervision?

Systemic (or macroprudential) supervision differs from microprudential regulation in two key respects. The main purpose of microprudential regulation is to protect the deposits held by individual financial institutions, and hence the main focus of this type of regulation is the financial condition and management of each individual deposit-taking financial institution in the financial system.

In contrast, the focus of macroprudential regulation is on the vulnerabilities which could threaten the systemic stability of the financial sector, rather than the failure of individual financial institutions. One or more banks could fail without affecting the systemic stability of the financial system. In addition, macroprudential regulation encompasses all financial institutions and markets which could have systemic consequences as illustrated by Figure 1. A key aspect of macroprudential analysis therefore, is the surveillance and monitoring of systemically important institutions and markets.

1.3. The Bank of Uganda's Role in Maintaining Financial System Stability

Within the BoU, financial stability analysis will involve continuous assessment of potential systemic risks to the Ugandan financial system and the development of policies to mitigate those risks.

The BoU will collaborate with the other financial sector regulators in Uganda (Capital Markets Authority and Insurance Commission) to monitor systemic risks. The presence of foreign-owned banks in the Ugandan financial system has made it imperative to exchange information with regulators in the home countries of these banks.

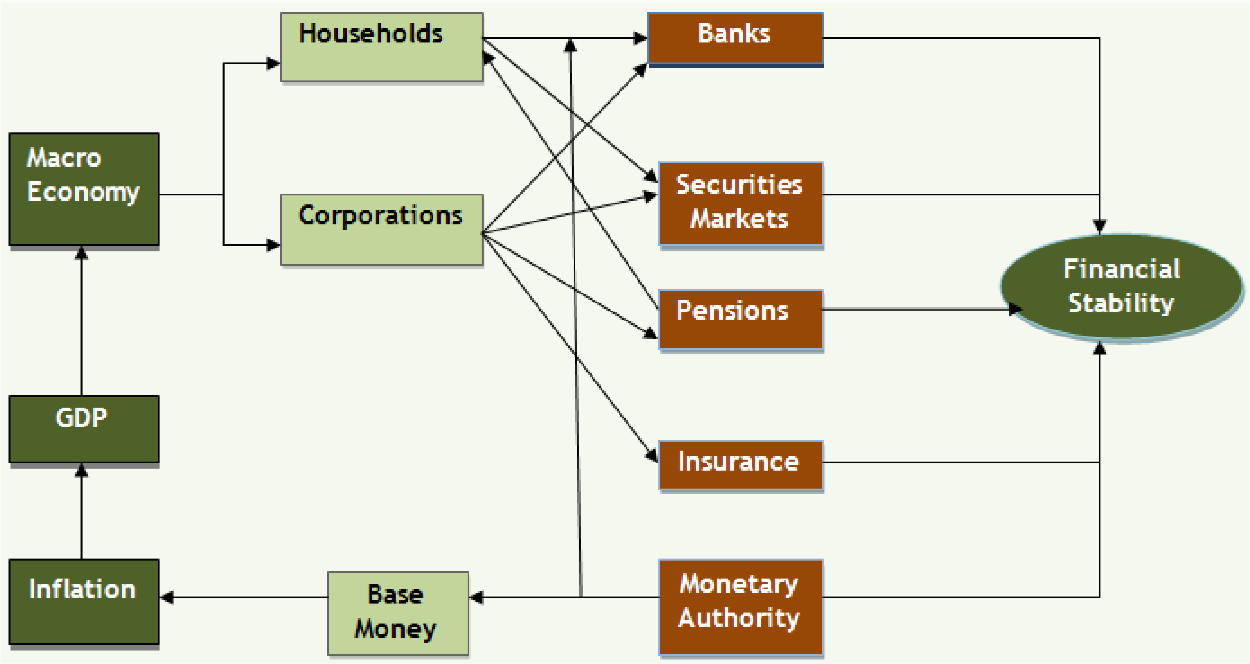
A key activity will be the provision of coherent and timely policy guidance on issues relating to financial stability.

The Financial Stability Report

The *Financial Stability Report* will be produced bi-annually. The objectives of the *FSR* are to evaluate the soundness of the Ugandan financial system, and to highlight potential areas of vulnerability in the financial sector that could pose a risk for systemic stability.

This first edition of the *FSR* includes an assessment of how the global financial crisis affected the financial sector in Uganda. Subsequent reports will discuss specific policy topics of relevance to systemic stability. Banks dominate the Ugandan financial system and are crucial to the systemic stability of the system. Consequently, most systemic risks arise from banks rather than from non-bank financial institutions. This initial FSR, therefore, focuses on the banking sector.

Figure 1: Link between financial stability and the macroeconomy



2. The International Environment

2.1. Overview

This section covers developments in the world economy in the build up to and during the global economic crisis, with special focus on advanced economies, emerging markets and the East African region. This analysis is important because international and regional developments feed into the domestic economy and can pose significant risks to the stability of the financial system.

Shocks in global financial markets permeated into the domestic financial system through lower exports, reversals of short term capital flows and lower remittances, which put pressure on the domestic currency. There are important trade linkages between the domestic economy, the East African region and some emerging markets particularly China. The East African region is particularly important because of the strategic trade linkages between member countries of the East African community. Another issue of concern to financial stability is the increase in the number of bank subsidiaries, which have the same parent company, and operate in all the East African countries.

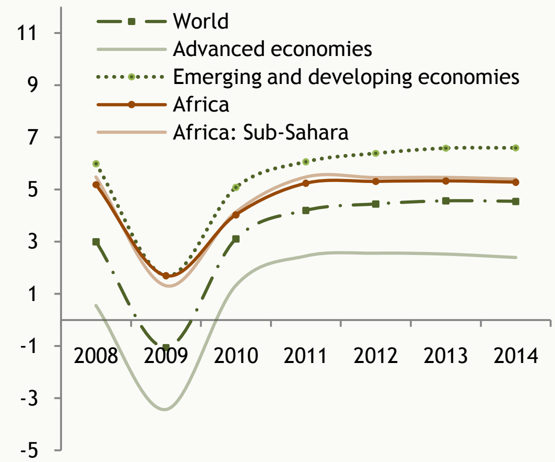
2.2. Advanced Economies

The financial crisis in developed economies, triggered by losses in the US sub-prime mortgage market, has affected most economies around the world. The financial crisis led to the most severe global economic downturn since the Second World War.

Many major economies suffered sharp declines in economic activity in 2009. The International Monetary Fund (IMF) projects that global output growth declined by 1.1 percent in 2009 (Chart 1).

Chart 1: Annual GDP growth

(*Annual percent change, figures beyond 2008 are forecasts*)



Source: IMF, WEO Database Oct 2009

Global growth is projected to recover in 2010, driven by growth in the emerging markets and developing economies. Countries in Africa are projected to have positive growth with sub-Saharan-Africa projected to grow by 1.3 percent in 2009 and 4.1 percent in 2010[2]. Output growth in advanced economies is projected to remain weak in 2010.

The global financial crisis

The origins of the global financial crisis can be traced back to the crisis in the U.S housing market. Loose credit conditions and rising house prices over the past decade led to the growth of mortgage lending to people with weak credit history and a greater-than-average risk of defaulting on loans, that is, the sub-prime mortgage market. A high proportion of sub-prime loans were securitized into mortgage backed securities, which were then traded widely and held as investments by a wide range of financial institutions. However, the mortgage backed securities and many other complex instruments (including securitized

[2] IMF, World Economic Outlook, October 2009.

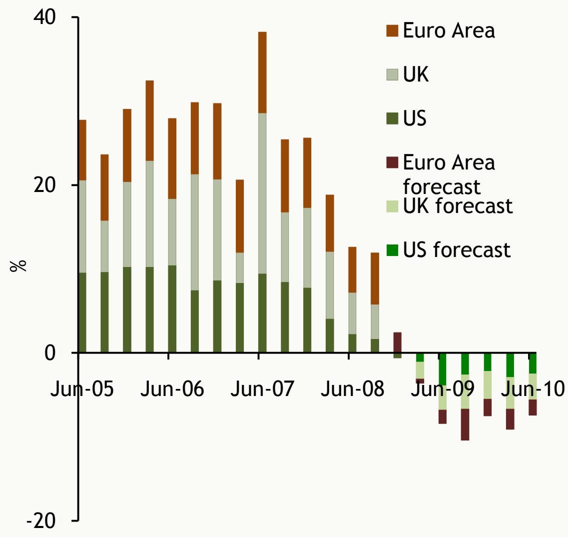
pools like collaterised debt obligations (CDOs)) proved very difficult to value once house prices begun to fall and liquidity evaporated.

As a consequence, financial institutions that held large positions in these collateralized debt obligations suffered large losses. In addition, the risks inherent in these complex assets appear to have been mispriced largely because they were difficult to estimate. A lack of transparency as to where risks were distributed within the financial system led to a sharp drop in liquidity, with some financial institutions which relied on wholesale markets to raise liquidity driven to near insolvency because of the scarcity of short-term funds.

The uncertainty in the markets pushed interbank interest rates and the price of insuring debt sharply upwards. Several financial institutions in Europe and U.S reported substantial write-downs of their assets, which undermined their capital positions and, in some cases, led to their failure. In addition firms that sold instruments that insure against default like credit default swaps (CDS) came under increased pressure since the value of such securities rise sharply when the securities they insure against collapse in value.

To protect their own balance sheets in the face of heightened uncertainty about the value of a wide range of assets, financial institutions took measures to minimise losses, strengthen liquidity and conserve capital, one of the consequences of which was the reluctance to extend credit to businesses and individuals (Chart 2).

Chart 2: Credit growth of advanced economies *(monthly percent changes)*



Source: WEO Database, IMF

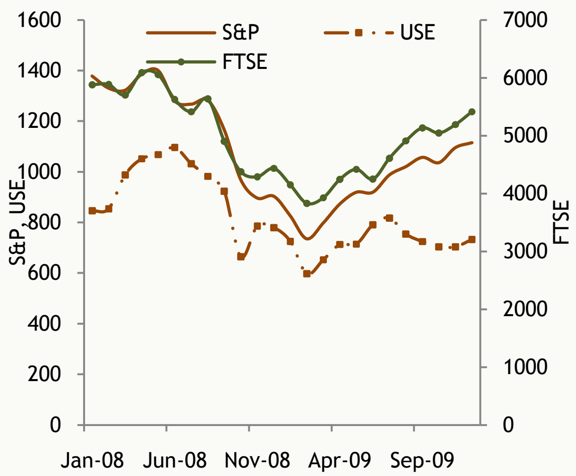
Because of the severity of the financial crisis, several national governments introduced extraordinary measures to counter disruptions in financial markets, which in some cases were agreed through a common approach such as that taken by European Union members. These efforts included reducing interest rates, unprecedented infusions of additional liquidity to the markets, increasing deposit guarantees, fiscal stimulus, and capital injections into a number of financial institutions.

The joint efforts by authorities were aimed at restoring confidence in the credit and other markets and stimulating their economies. Although it is still too early to judge the success of the extraordinary measures taken by governments, initial evidence suggests that confidence is slowly returning to the markets, liquidity is flowing again though credit extensions are still sluggish.

Financial institutions are exercising more caution towards risky investments and have accumulated more liquid and safer assets. A key challenge for the authorities is how to properly manage their exit strategy from the extra ordinary measures that they have implemented in a way that will not disrupt the markets or deflate aggregate demand.

As bank profitability has recovered, international markets have also rebounded. The domestic equity market is showing signs of a recovery, although with a lag as depicted in Chart 3.

Chart 3: S&P500 Index, and FTSE100 Index, USE All Share Index, *(monthly closing levels)*



Source: Bank of Uganda and Reuters

Implications for Uganda

Capital markets in emerging and developing markets are integrated with capital markets elsewhere in the world. The USE All Share Index has a correlation coefficient of 0.83 with the S&P500, a proxy for the largest listed companies in the US, and 0.75 with the FTSE 100, a proxy for the largest listed companies at the London stock exchange (Table 1).

Table 1: Correlations: USE All Share, S&P500, FTSE100 *(correlation obtained from monthly data)*

	S&P	FTSE	USE
S&P	1.00	0.98	0.83
FTSE	0.98	1.00	0.75
USE	0.83	0.75	1.00

Source: Bank of Uganda and Reuters

This correlation is relevant in two respects. It reinforces the widely held, although hitherto unverified, belief that events in the world economy have a direct bearing on domestic financial markets. Second, as long as the correlation coefficients between Uganda's equity markets and those in advanced countries are not unity, foreign investors have a motive to invest in the local equity market in order to diversify their portfolios. As the events of October 2008, when there was a large portfolio outflow at the height of the crisis, demonstrate, Uganda's equity market is affected by the changes in risk appetite and the attendant volatility in international capital flows.

2.3. Emerging Markets and Developing Economies

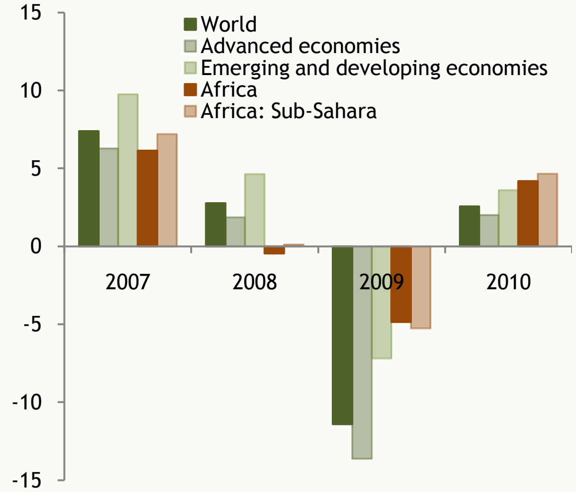
Emerging market and developing economies were not immune to the effects of the global financial crisis. The crisis led to macroeconomic instability, balance of payments problems and reduced economic growth in many countries.

The extent to which individual countries were affected by the crisis depended mainly on their financial structures, their integration with global financial markets and their balance of payments positions. Those countries, including several in Eastern Europe, with large current account deficits and dependence on short term foreign capital were the most vulnerable to the crisis in the global financial markets. This was because the global crisis severely curtailed their access to foreign capital, forcing them to cut sharply their current account deficits, usually with deflationary consequences.

The global recession reduced world trade, which is projected to fall by 12 percent in real terms in 2009. The exports of emerging and developing economies are forecast to fall by

6.4 per cent in 2009, but to recover slightly in 2010 with growth of 1.2 percent[3].

Chart 4: Export Volumes of goods and services *(Annual percent change, figures beyond 2008 are forecasts)*



Source: IMF, WEO Database Oct 2009

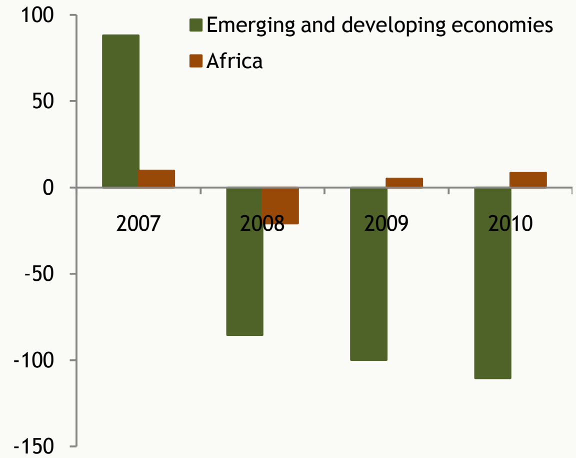
Private portfolio flows

Private portfolio capital flows experienced sharp reversals in emerging and developing countries, including those in the Africa region (Chart 5). This reversal may have been triggered by liquidity pressures facing overseas investors in their home countries as well as a desire to reduce their exposure to markets perceived to be more risky.

The sudden reversal of portfolio flows demonstrates the volatility associated with private portfolio investment in the financial markets of emerging and developing economies.

[3] ibid.

Chart 5: Net Private Portfolio flows *(US$ billions)*



Source: IMF, WEO Database Oct 2009

2.4. Developments in the East African Region

The increased integration of the East African Community (EAC) has brought to the fore the regional dimension of systemic risks, arising from the strong trade linkages and links between financial institutions in the partner states of the EAC.

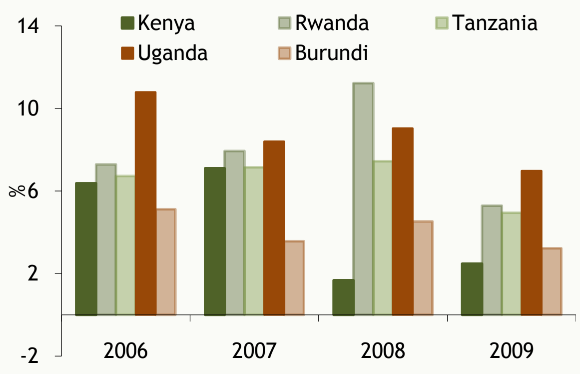
For the most part, the financial systems of the EAC countries were protected from the turmoil in global financial markets because they had limited exposures to the toxic assets that triggered the financial crisis.

GDP Growth

All of the five EAC economies managed to record positive growth in 2009, although, with the exception of Kenya, growth was lower in 2009 than it had been in each of the preceding three years. Average GDP growth in the region is expected to drop from a rate of 6.8 percent in 2008 to 4.6 percent in 2009[4] (Chart 6).

[4] ibid.

Chart 6: Changes in regional GDP growth
(annual percent change)

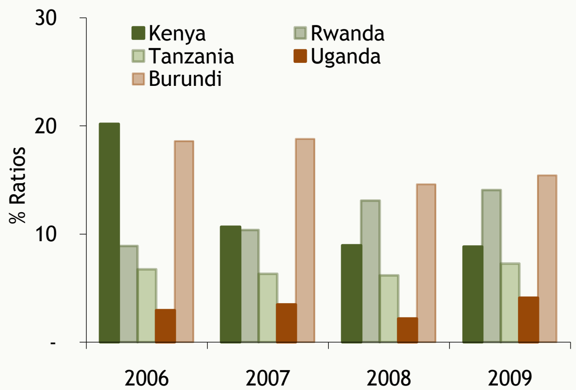


Source: IMF, WEO Database Oct 2009

Asset quality

Table 2 and Chart 7 show that the ratio of NPLs to total loans increased in Rwanda, Tanzania and Burundi, while the ratio was stable for Kenya.

Chart 7: Non-performing loans as a percentage of total loans

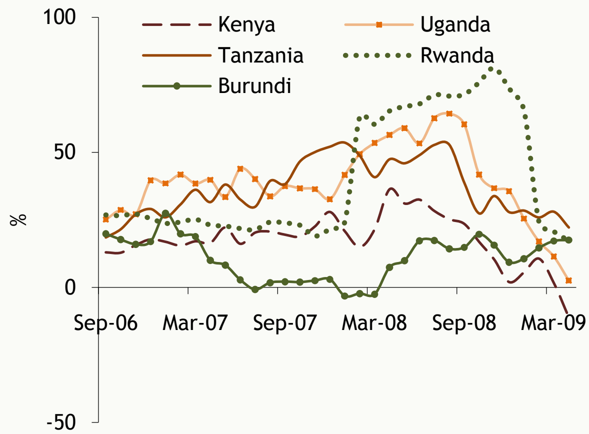


Source: Central banks of Kenya, Rwanda Tanzania, Uganda and Burundi

Bank lending

Chart 8 shows that credit extended to the domestic private sector grew strongly in 2007 and the first half of 2008 but then decelerated from August 2008. The sharp fall in growth of private sector credit during this period corresponds with movements that were observed across the globe as banks faced liquidity pressures and struggled to strengthen their capital positions.

Chart 8: Monthly growth in credit extended to the private sector by banks

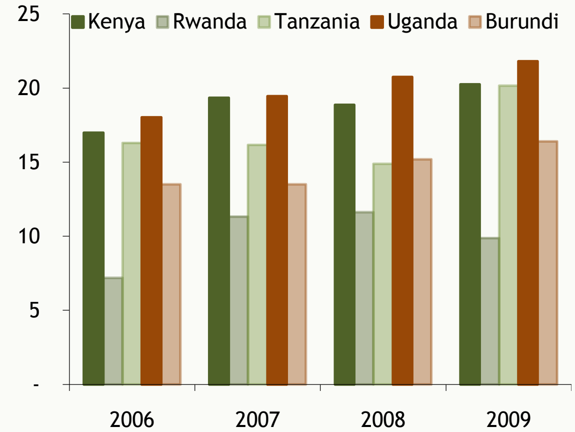


Source: Central banks of Kenya, Rwanda Tanzania, Uganda and Burundi

Capital adequacy, profitability and liquidity

Banks in the East African region maintained relatively strong capital positions as illustrated by Chart 9. The average capital adequacy ratio for the region rose from 15.9 percent in 2007 to 17.7 percent in March 2009. Table 3 also shows that the global crisis did not adversely affect banks' profitability and liquidity.

Chart 9: Capital adequacy ratio for banks in the East African region (*figures as at Sep 09*)



Source: Central banks of Kenya, Rwanda Tanzania, Uganda and Burundi

Concluding remarks

The global financial crisis had a much more severe impact in developed economies than in emerging markets, which partly reflected the deeper and more sophisticated financial systems of the former. It also reflected the closer links between banks and other financial markets in the developed countries, such as the reliance of some banks on wholesale markets for funding. The crisis also showed that a financial crisis can build up very quickly into a systemic crisis and that even apparently well capitalized banks can be vulnerable to distress when financial markets are under stress.

Emerging and developing economies experienced a smaller slowdown in economic activity relative to the more advanced economies. The impact of the global financial crisis on East African financial systems was relatively small and the banking sectors in East Africa have remained well capitalized, profitable and liquid.

3. Developments in Uganda's Economy

3.1. Overview

This section analyses the developments in Uganda's economy and financial markets in 2008/2009. Although the crisis had a limited impact on Uganda's economy, it served to expose potential vulnerabilities in the macroeconomy and the financial system.

3.2. Developments in the Ugandan Economy

Growth in the Ugandan economy slowed in FY 2008/09, largely due to exogenous shocks, which affected both the current and capital accounts of the BOP and reduced growth in aggregate demand.

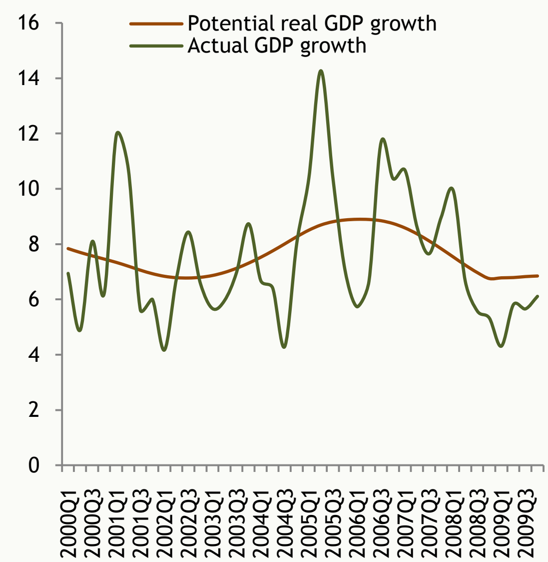
Slower growth in aggregate demand pulled real GDP growth below potential, with GDP growing by 5.5[5] percent in 2008/2009 (Chart 10), lower than the 9.5 percent growth projected in mid 2007. Nevertheless, real growth in Uganda was higher than the average of the 1.3 percent projected for sub-Saharan countries[6] in 2009.

The drop in GDP growth was mainly due to dampened global demand for commodity exports, depressed commodity prices on the world market, drop in remittances, reduced demand for construction activity and a downturn in the tourism sector.

[5] BoU Monthly Review of Reserve Money Programme, November 2009

[6] ibid.

Chart 10: GDP performance: Actual versus potential



Source: Bank of Uganda

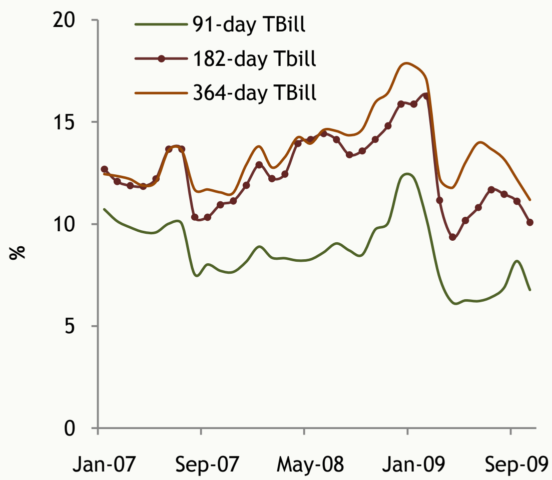
3.3. Financial Markets

Uganda's financial markets were also affected by the volatility in global financial markets, mainly through falls in asset prices and a reversal of portfolio capital flows.

Bond market

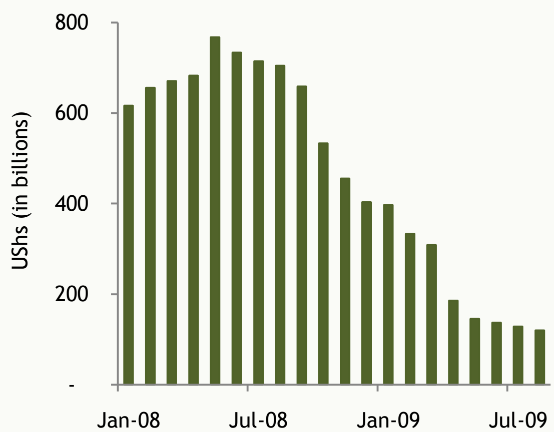
At the height of the crisis, in the fourth quarter of 2008, there was a rapid exit of portfolio investors from Ugandan government debt markets and a consequent rise in the yields on Treasury Bills, as indicated by Charts 11 and 12. The rapid exit of offshore portfolio investors could have been triggered by liquidity needs at home rather than a reassessment of economic fundamentals. The reversal of portfolio capital flows also contributed to the rapid depreciation of the Ugandan Shilling as depicted in Chart 13. This highlights the vulnerability of Uganda's debt markets and exchange rate to the activities of portfolio investors who constituted 20 percent of investors in the government securities market in September 2008.

Chart 11: Annualized Treasury yields



Source: Bank of Uganda

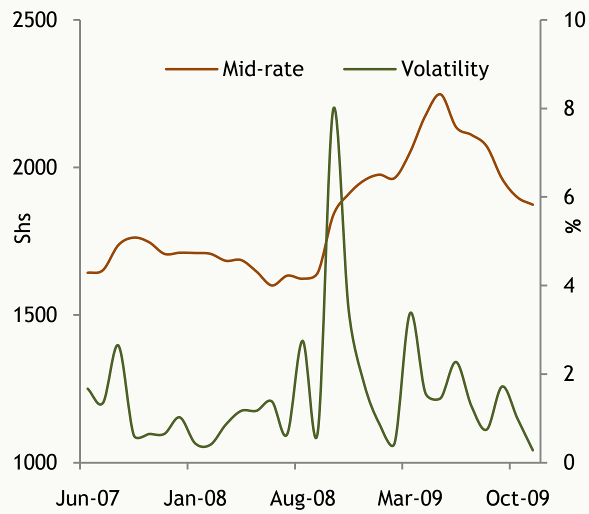
Chart 12: Monthly offshore holdings in Uganda's debt markets



Source: Bank of Uganda

However, since March 2009, the yields on all maturities of government securities have declined as a result of a reduction in the issuance of Treasury securities, increased liquidity in the banking system, a fall in domestic inflation and, following the rebound of the exchange rate from May 2009 onwards, expectations of further appreciation of the shilling.

Chart 13: Monthly nominal exchange rate and volatility



Source: Bank of Uganda

The foreign exchange market

The Uganda shilling faced sustained depreciation pressures, falling by 21 percent against the US dollar for the year ending October 2009, as indicated in Chart 13. The depreciation of the Shilling was triggered by the large outflow of portfolio capital in mid 2008 as offshore investors rapidly sold local assets as they sought to exit the domestic market and persisted over the next twelve months, driven by weaker export earnings and reduced remittance inflows in the current account of the BOP. This further increased liquidity pressures on banks. To stem the depreciation of the shilling, the BOU intervened in the interbank foreign exchange market (IFEM), selling US$235 million on a net basis during the year to June 2009. The depreciation of the Shilling began to be reversed in May 2009.

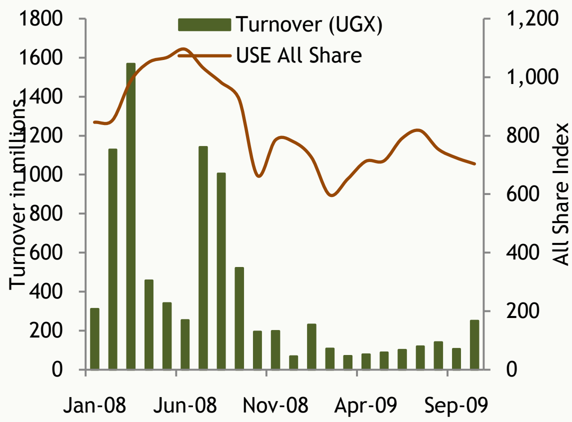
Equity market

Domestic equity prices recorded a rapid downward trend in the second half of 2008, mirroring the trend observed in virtually all equity markets around the world. The biggest decline was recorded in October 2008, when the Uganda Securities Exchange (USE) All

Share Index fell by 28.2 percent, as illustrated by Charts 14 and 15 below.

In the year to June 2009, the USE All Share Index fell by 27.8 percent to 790.8. Turnover also dropped to UShs. 47.9 billion during the period of July 2008 to June 2009, compared to UShs. 91.7 billion from July 2007 to June 2008. This could be attributed to increased risk-aversion of both foreign and local investors and general bearish market sentiment across the globe. This risk aversion to the equities markets could have translated into a rise in bank deposits and postponement of the planned initial Public Offering (IPO) of some companies.

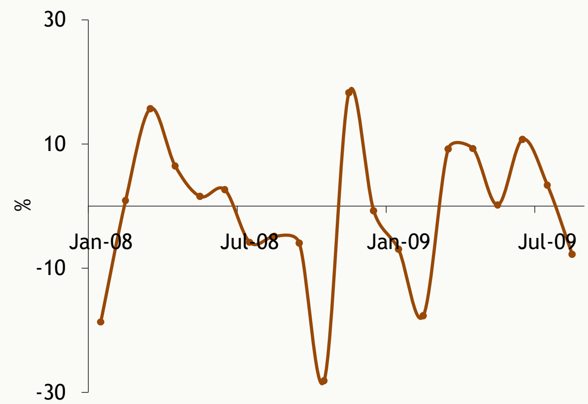
Chart 14: Monthly Performance of the Uganda Securities Exchange (USE)



Source: Bank of Uganda

The share prices of some of the banks that are listed on the USE fell sharply during October 2008. The volatility in asset prices might raise the cost of issuing new equity, if banks need to raise new capital.

Chart 15: Percentage change in USE All Share Index



Source: Bank of Uganda

Although trading started to recover slowly in May 2009, turnover remained considerably lower than in previous years.

3.4. Conclusion

The financial crisis had limited impact on the Ugandan economy. Real GDP growth fell below its long run potential. The effect of the crisis was manifested in the volatility of the equity market, which experienced sharp declines in turnover, the sharp depreciation of the exchange rate and a slight decline in exports.

4. Developments in Banking Institutions

4.1. Overview

The banking sector in Uganda has not suffered the large deterioration in asset quality that affected banks in many countries, nor did it have direct exposure to the impaired assets which were at the heart of the US financial crisis. Ugandan banks were shielded from the effects of the global financial crisis because of their limited integration with global financial markets. Furthermore, Ugandan banks were much less leveraged than their counterparts in developed countries. Most Ugandan banks are well capitalised with capital levels in excess of the regulatory minimum requirement (Chart 16). Bank asset quality is generally good.

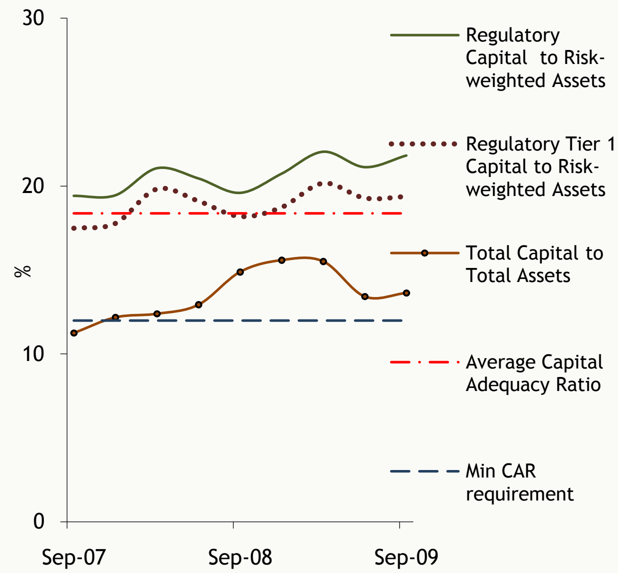
Nevertheless, Ugandan banks felt the impact of the global crisis indirectly through pressures on liquidity, increased funding costs especially in the interbank market and, higher levels of non-performing loans caused by weaker economic activity. Notwithstanding these effects, banks appear to have weathered the global financial crisis well, as displayed by the indicators in Table 2.

As the global crisis unfolded, three key issues became of particular concern: funding and liquidity pressures, changes in asset quality such as loan quality deterioration, and bank risk profiles and effects of stress on capital and earnings.

4.2. Capital Adequacy

Ugandan banks remained well capitalised during the recent financial crisis. As Chart 16 and Table 3 in the Appendix shows, the ratio of tier one capital to total risk-weighted assets of Ugandan banks rose steadily to an average of 19.4 percent in September 2009. The average capital adequacy ratio of Ugandan banks have remained well above the regulatory minimum of 12 per cent for the past three years.

Chart 16: Measures of capital adequacy
(Quarterly percentage ratios)



Source: Bank of Uganda

4.3. Funding and Liquidity

Banks, including the domestic subsidiaries of foreign-owned banks which suffered financial distress in their home countries, maintained adequate levels of liquidity. Ugandan banks fund their liabilities almost entirely from domestic deposits and, largely because public confidence in the soundness of Ugandan banks was not undermined, there were no runs on banks by domestic depositors. Overseas debt markets are not a significant source of funds for the domestic banking sector, nor are domestic wholesale funding markets, which are very small.

Funding conditions and slight tightening of liquidity

However, during the six months to December 2008 there was a slight tightening of liquidity in the banking sector[7]. Liquidity pressures were further exacerbated by a rise in demand for credit from domestic banks by companies whose access to credit abroad was impaired by the financial crisis. As a result, banks had to compete more vigorously for liquidity in domestic markets.

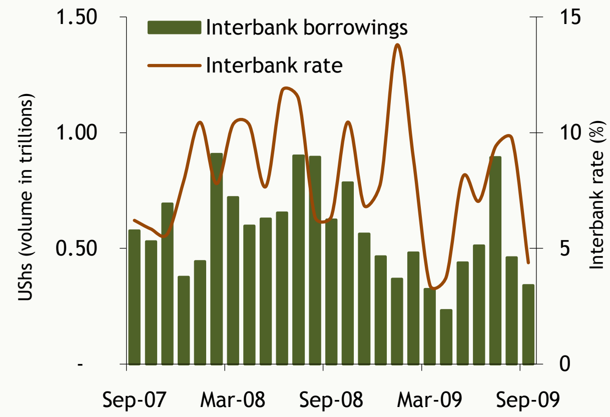
Interbank markets

The volume traded in the interbank overnight market increased sharply, averaging UShs. 704.9 billion each month between July and December 2008, compared to an average of UShs. 449.1 billion during the same period in 2007. This was accompanied by a sharp rise in interbank rates between October 2008 and January 2009 as shown in Charts 17 and 18. The increase in liquidity pressures further contributed to the growing volatility in the market.

A number of banks accessed liquidity support from the Central Bank through the standing facility, while others discounted their securities. Subsequently, the BoU reduced the policy margin in March 2009.

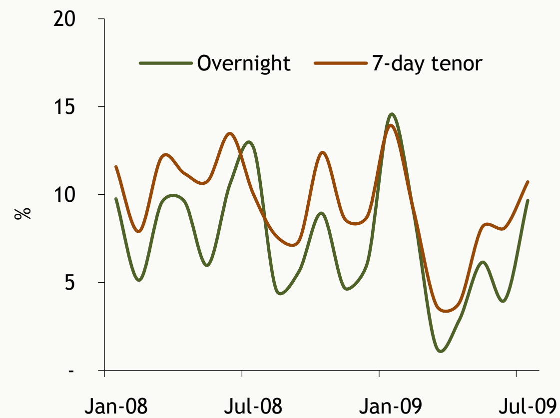
Overnight rates in the interbank market became more volatile, as shown in Chart 17. The overnight rate and the 7-day rate in the interbank market indicated strong volatility between June 2008 and June 2009. After peaking in January 2009, the interbank rate dropped sharply in March 2009 but then rose again sharply.

Chart 17: Volume of overnight interbank lending *(Monthly interbank activity)*



Source: Bank of Uganda

Chart 18: Interbank rates



Source: Bank of Uganda

Reliance on deposits for funding ameliorated liquidity pressures

Chart 19 shows that the banking sector's deposits expanded by 45.1 percent or UShs. 1,683.2 billion over the two years to November 2009.

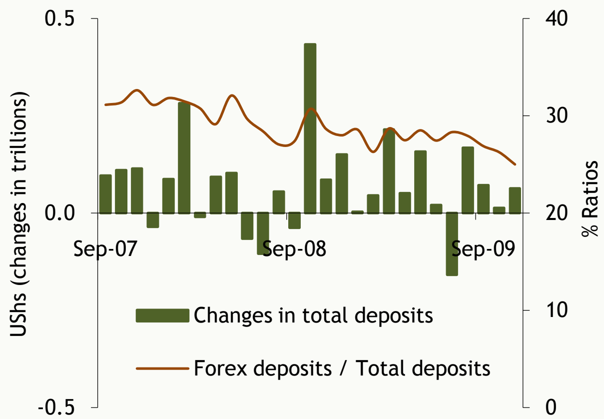
As the global crisis unfolded, total deposits grew strongly by UShs. 433.1 billion in October 2008. This level of deposit expansion was the largest single monthly increase on record, even when revaluation effects (on foreign currency deposits) are taken into account.

[7] BoU, Survey of Farm Credit, 2008

Bank deposits rose as local investors sought the relative safety of banks vis-à-vis the securities market, although there was a decline in July 2009. Total deposit liabilities of banks rose by 17.3 percent to reach UShs. 5.4 trillion in the year to November 2009.

Despite the growth in deposits, banks faced pressures that arose from slower growth of foreign currency deposits since mid 2008 as shown in Chart 19. Foreign currency deposits declined in late 2008.

Chart 19: Growth in deposits *(Monthly changes and percentage ratios)*



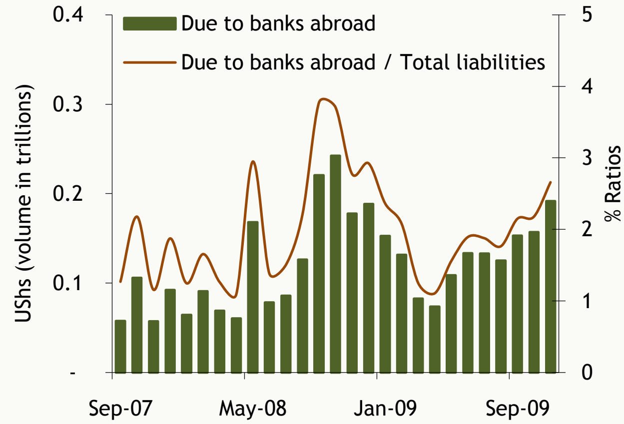
Source: Bank of Uganda

Liquidity pressures increased as overseas investors sought to leave the domestic markets between August and October 2008

Chart 20 shows an increase in liabilities owed to foreign banks between September 2008 and January 2009 which reflected a temporary build up of placements in the banking system as overseas banks liquidated their government securities and exited the securities market. The repatriation of these funds over the following months slightly raised liquidity pressures in some banks.

Chart 20: Liabilities due to commercial banks abroad

Monthly volumes and percentage ratios



Source: Bank of Uganda

However, banks' overall liquidity remained good. The steady decline in the level of liquid assets as a percentage of total assets to 28 percent in September 2009, shown in Table 2, reflected the structural changes in the sector as banks moved to increase their lending. The above changes are also shown by the rise in the ratio of total loans to total deposits to 70 percent in September 2009 from 55.3 percent in September 2007. Borrowing from the central bank as a percentage of total deposits remained below 0.1 percent during the first half of 2009.

Actions by the central bank to ease liquidity pressures

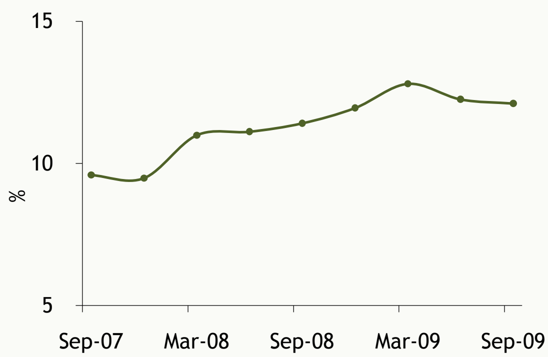
The central bank took several actions to provide adequate liquidity to the banking sector and the economy. First, Bank of Uganda reduced the policy margin and hence the Bank rate (the rate at which banks borrow from the central bank) to 3.4 percent in March 2009 and later further down to 3 percent in September 2009. Reducing the policy margin was aimed at making it easier for banks to access liquidity from the Bank of Uganda in cases where they were unable to access their normal funding channels including the interbank market.

Financial leverage

Another factor behind the global financial crisis was that globally, most banks were highly leveraged.

Chart 21 below illustrates the trend of the leverage ratio for Ugandan banks, which increased steadily from 9.6 percent in September 2007 to 12 percent in September 2009, indicating that leverage fell. By the time the crisis emerged, Ugandan banks were well capitalised, largely because of very strong earnings in recent years. A key challenge for the banks going forward will be to maintain strong capital positions if real economic activity deteriorates.

Chart 21: Tier 1 capital as a percentage of total assets *(Quarterly percentage ratios)*



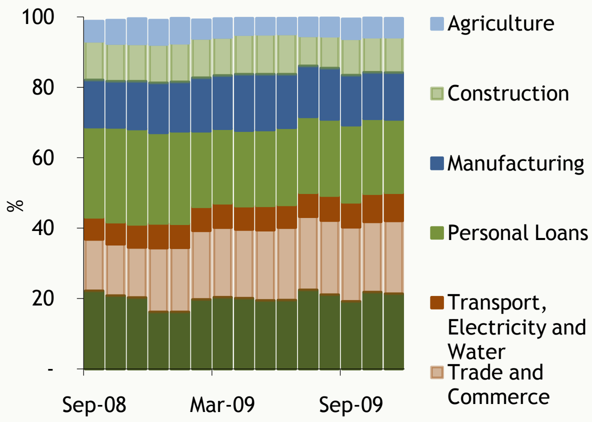
Source: Bank of Uganda

4.4. Asset Quality

The growth in bank lending to businesses and households was rapid, at a rate of 30 percent in the year to September 2009. The rapid expansion in bank lending took place against a backdrop of challenges related to risk evaluation by banks arising from poor bookkeeping by SMEs, multiple borrowing, fraud and, problems with enforcing loan recovery[8]. These challenges, together with the increased exposure of banks to the trade and household sectors (Chart 22 and Table 3) may pose a challenge if growth prospects deteriorate, exposing banks to credit risk.

[8] Bank of Uganda, "Bank Lending Survey ", December 2008.

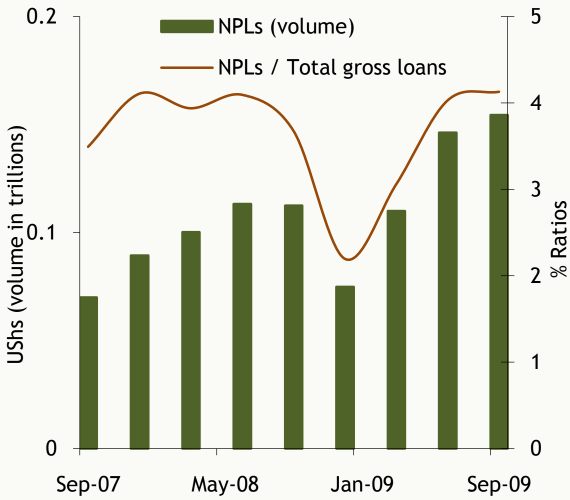
Chart 22: Sectoral distribution of loans as a percentage of total loans *(Monthly ratios)*



Source: Bank of Uganda

The main indicator of banks' asset quality is non-performing loans (NPLs) as a proportion of the total gross loans. This ratio rose to 4.1 percent in September 2009 from 3.1 percent in March 2009, as illustrated in Chart 23. Although the increase in the ratio and level of NPLs does not appear to be a significant systemic threat at this point, the BoU will continue to monitor loan performance and the levels of loan concentration.

Chart 23: Bank asset quality *(Quarterly volumes and percentage ratios)*



Source: Bank of Uganda

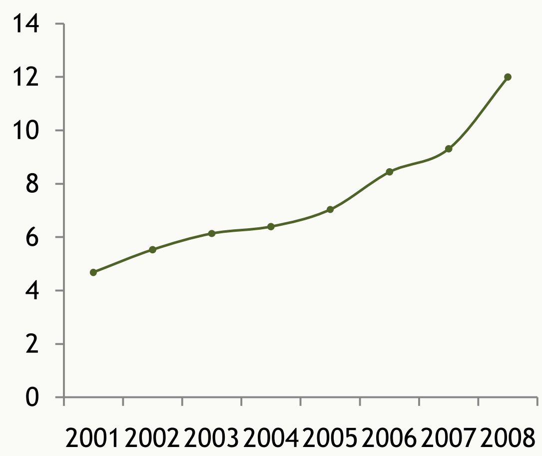
Overall, during the last two years, the NPLs to total loans ratio has fluctuated between 2.9 per cent and 4.1 per cent. It is also within the trend average for the past six years and still well below the highs witnessed in the mid 1990s when several banks failed.

Asset growth

A key development prior to the financial crisis was the rapid growth in debt levels in most countries. In many countries, growth in credit outstripped that of GDP. For example, the ratio of bank loans to nominal GDP doubled to 103 percent in 2007 for South Africa, while for Switzerland the ratio had reached 746 percent by end 2008[9].

For Uganda, this ratio doubled between 2004 and 2009 to 12.2 percent as shown in Chart 24, although this is still far below the average for sub-Saharan Africa and is very low compared to other countries. The increase in credit as a percentage of GDP reflects both the financial deepening over the period and the increased share of loans in banks' asset portfolios.

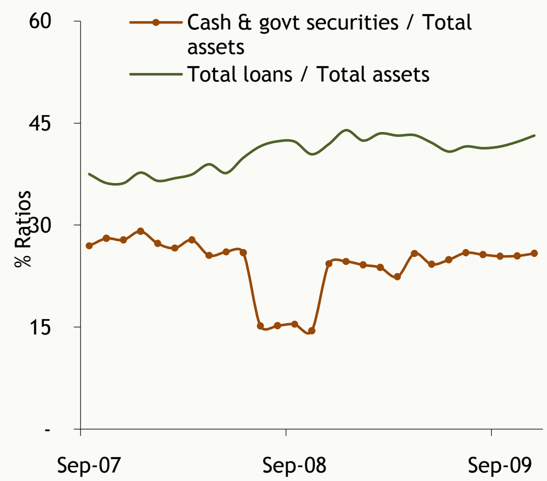
Chart 24: Credit as a percentage of GDP
(Annual percentage ratios)



Source: Bank of Uganda

The total assets of the banking system grew strongly over the two years to September 2009, by 63.2 percent to Shs. 8,442 billion. While the ratio of government securities to total assets remained steady between September 2007 and September 2009 at approximately 24.1 percent as indicated by Chart 25, the ratio of gross loans to total assets rose from 37.5 percent to 43.2 percent during the same period.

Chart 25: Loans, cash and government securities as a percentage of total assets
(Quarterly percentage ratios)



Source: Bank of Uganda

Lending

The volumes of monthly loan extensions, capitalised interest and recoveries as percentages of total gross loans have been registering downward trends since December 2007 as shown in Chart 27, with the ratio for extensions dropping by 29 percent between then and September 2009. At the same time, the amount of interest capitalised and other amounts credited to the outstanding balance have generally been on the rise since July 2008, with significant peaks in September 2008 and January 2009. These movements in the structure of monthly advances correspond with those that have been observed in NPLs.

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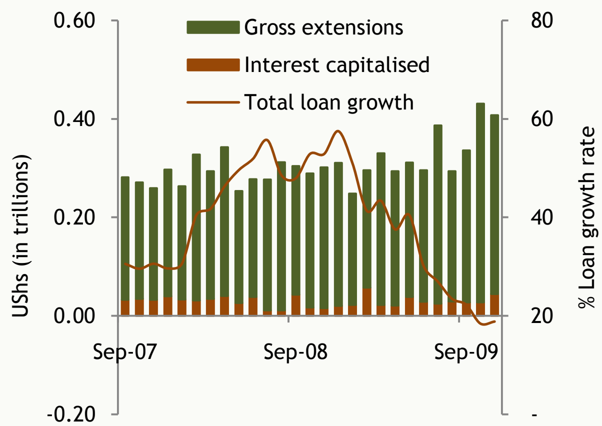
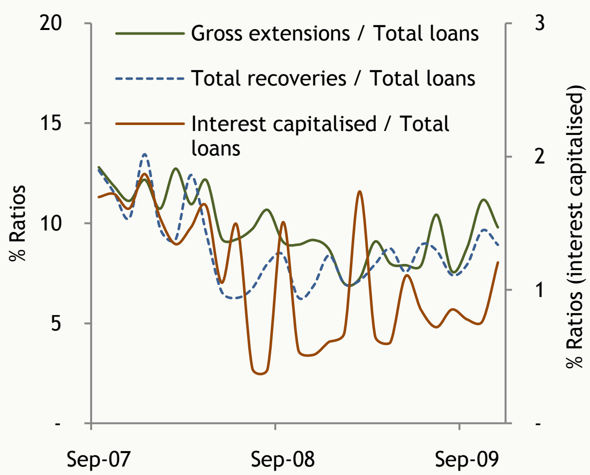
[9] Source: Bloomberg LP

Chart 26: Bank lending *(Monthly levels and percentage growth rates)*



Source: Bank of Uganda

Chart 27: Breakdown of monthly loan operations by commercial banks *(Monthly percentage ratios)*



Source: Bank of Uganda

The slowdown in lending reflects a tightening of credit standards by banks as well as lower deposit growth and the slow-down in real GDP growth.

Lending to businesses

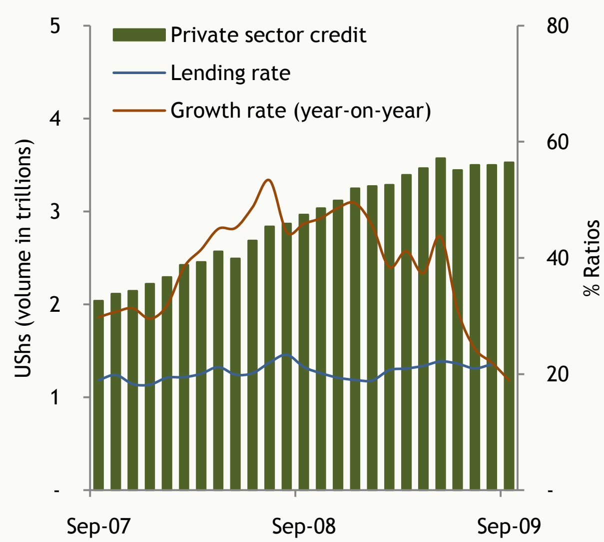
Business lending grew by approximately 32 percent in the year to November 2009. As seen in Table 3, most of the growth in lending was to the trade and commerce sector, especially to finance imports, whose share of total loans rose by 6 percent to 20.7 percent.

Banks tightened credit availability, especially to SMEs

The bank lending surveys for December 2008 and June 2009 showed that banks tightened their lending standards. Overall, 57 percent of lenders tightened lending to SMEs, while 40 percent tightened credit for large enterprises. In addition, 43 percent of the banks reported a decline in the availability of long-term loans (more than 12 months).

The tightening in the standards and credit terms and conditions was generally associated with falling interest margins and stricter collateral requirements. If the trends that were observed in liquidity levels continue and the expectations regarding general economic activity remain constrained, these factors may contribute to tighter credit conditions, which may eventually affect economic growth. Chart 28 shows that average lending rates have remained high at around 20 percent.

Chart 28: Private sector credit growth and lending rate *(Monthly levels and percentage rates)*



Source: Bank of Uganda

Lending to households

Bank lending to households and individuals has continued to expand strongly. Table 3 shows that by end-September 2009, lending to households stood at Shs. 980 billion, that is, 26 percent of total loans, most of which represented consumer lending.

Mortgage lending

As shown in Chart 29, bank lending for residential and commercial mortgages stood at Shs. 612.4 billion at the end of June 2009, accounting for 16.4 percent of total loans.

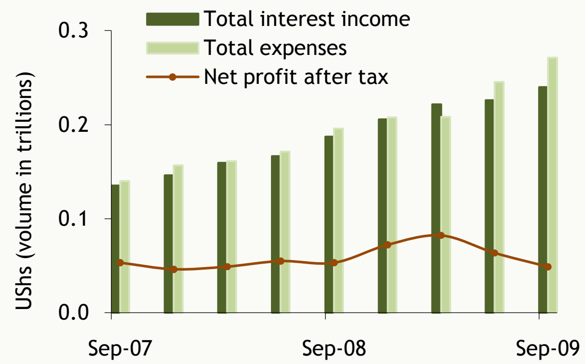
Chart 29: Bank credit for mortgages ***(Monthly data)***

Source: Bank of Uganda

4.5. Income and profitability

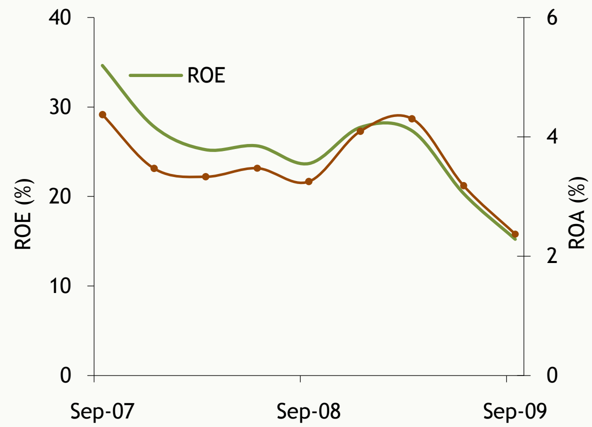
Profitability has remained stable, but has recorded a slight decline over the last four quarters. Measures of bank profitability including the return on equity and return on assets remained relatively high between March 2008 and March 2009 as shown by Chart 31, but they started to decline in June 2009. This was mainly due to rising overhead and interest costs, which outstripped the growth of income.

Chart 30: Financial performance of the banking sector *(Quarterly data)*



Source: Bank of Uganda

Chart 31: Banks' profitability *(Quarterly ratios)*



Source: Bank of Uganda

In the period under review, income on advances continued to grow, buoyed by strong loan growth. Commissions' income also continued to rise, growing by 20 percent in the year to September 2009.

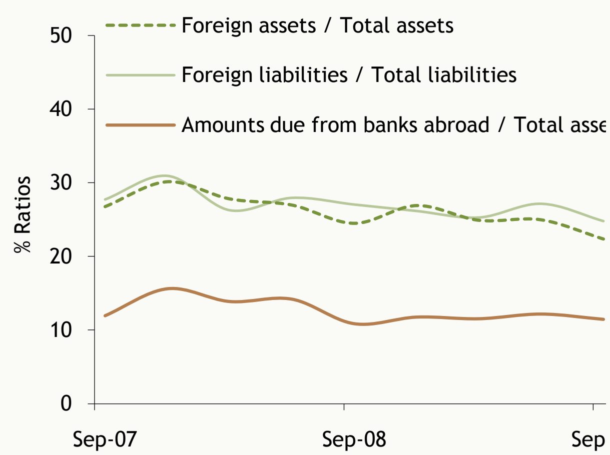
The growth in bank lending was the main contributor to a steady rise in after-tax profits, which expanded by 15.8 percent in the year to June 2009, maintaining the trend of the previous period. However, profits fell by 23 percent between June 2009 and September 2009, mirroring the effects of slowed credit growth and the growing cost of deposits during the period.

In an effort to appeal to the wider market, mostly by venturing into previously untapped segments and expanding their branch network, banks may have to lower lending rates. Because most operating costs are fixed in nature, banks face risks arising from a decline in interest margins. In addition, the average cost of deposits edged upwards to 4 percent in September 2009 (see Box A).

4.6. Foreign Currency Risk Exposure

Ugandan banks appear to have more prudently managed their currency risk exposures. Amounts due to foreign banks as a ratio of total assets remained at 2.4 percent in September 2009. Foreign currency-denominated loans have remained stable within a range of 24 percent to 30 percent of total loans, though with a slight decline to 22 percent in September 2009. Banks have also maintained net open positions that are much lower than the prudential limit of 25 percent of capital. Chart 32 shows the trend in banking sector's foreign currency risk exposure relative to total assets.

Chart 32: Banking sector's exposure to foreign institutions *(Quarterly ratios)*



Source: Bank of Uganda

4.7. Financial Innovations

Another characteristic of the global financial markets that led to the crisis was the innovations within the financial sector such as securitisation of mortgages. The Ugandan banking sector experienced the introduction of new products including auto and asset financing, financial leasing and an upturn in residential mortgage lending at many banks.

4.8. Conclusion

The turmoil in global financial markets has had a limited impact on the Ugandan financial sector. However, there has been a slight rise in risks in the sector over the recent months. These developments have been largely driven by the spill over effects from the crisis in global financial markets, rather than from direct exposure to international financial markets, investments in high-risk securities and complex instruments, funding constraints on banks or excessive leverage within banks.

The challenge in the medium term is to ensure that banks remain solvent, profitable and liquid, while allowing for the expansion and innovation that is required for the financial system to grow.

BOX A: Performance and outlook for the banking industry

The environment for banks to be more difficult as we go forward

Over the two years to March 2009, the Ugandan banking industry recorded very strong growth, largely driven by the buoyancy of the real economy and the high rates of profitability in the industry. Total assets of the banking system grew by 63.2 percent to Shs. 8,442 billion over the period. There was also a shift in the balance sheet structure, with a movement away from short-term liquid assets to longer-term investments, mainly loans. Banks remained well capitalized and highly profitable, largely driven by growth of interest income from lending, more than offsetting the effect of higher operational and overhead costs on income and profits.

However, over the last two quarters ending September 2009, conditions in the industry have become more difficult. Asset growth over each of the last two quarters has slowed down to 4.4 percent and 2.0 percent respectively, compared to the quarterly average growth of the last two years of 6.8 percent as depicted in Chart B. In addition, deposit growth was very sluggish, down from an average of 6.2 percent over the two years to March 2009, to 1.4 percent in September 2009.

These trends have affected bank performance and profitability. One measure of bank profitability, the Return on Equity (ROE) has fallen to 15.2 percent in September 2009, compared to an average of 28.0 percent over the previous two years to March 2009. The Return on assets (ROA) has also slowed to 2.4 percent in September 2009, from 4.3 percent in March 2009. This is mainly because the growth of expenses has outstripped income growth and the cost of deposits has edged upwards to 4 percent in the quarter ending September 2009, as shown in chart A.

Chart A: Cost of deposits

Interest expense on deposits as a percentage of average deposits

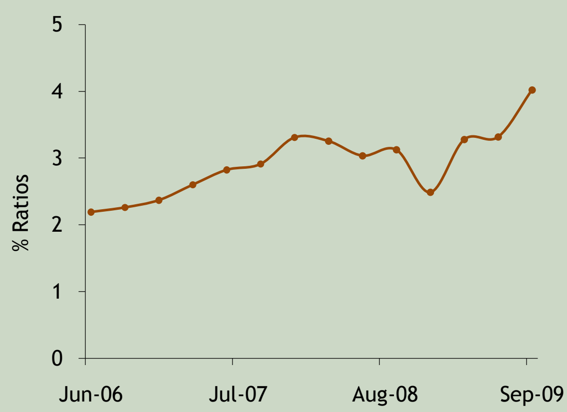
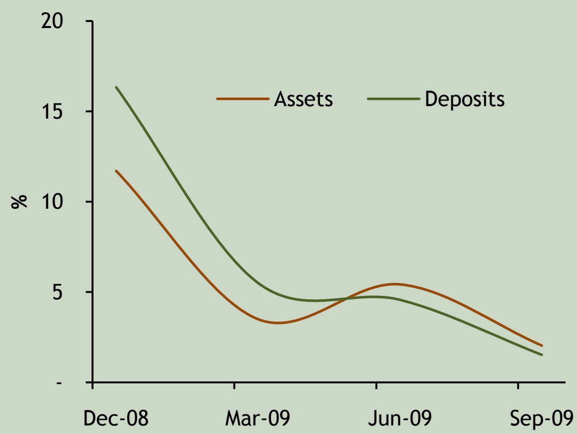


Chart B: Quarterly growth of deposits and assets



Lower earnings have not affected bank capital. The banking system faces several potential risks to profitability in the medium term. First, operating costs continue to rise, driven by higher energy and wage costs. Second, as the competition in retail lending intensifies, banks may be forced to lower lending margins to retain customers. Yields on lending are likely to come under pressure at least for prime borrowers. In addition, over the medium term inflation is likely to reduce further real interest rates on government securities and this will put downward pressure on loan interest rates. Because most operating costs are fixed in nature, banks face risks arising from a decline in interest margins, as this will reduce profitability.

Third, banks are also likely to experience lower demand for credit over the next year because aggregate demand in the economy has slowed down. In addition, the recent tightening of credit standards by banks indicates that they are concerned about loan quality[10].

[10] BoU Bank Lending Survey, June 2009

Tables

Table 2: Selected financial soundness indicators for countries in the East African Community (EAC)

		2003	2004	2005	2006	2007	2008	2009
Regulatory Capital to Risk-Weighted Assets								
	Uganda	16.95	20.49	18.31	18.02	19.46	20.74	21.82
	Kenya	17.25	17.10	16.82	17.00	19.35	18.87	20.25
	Tanzania	-	-	15.14	16.30	16.16	14.90	20.17
	Rwanda	9.00	10.60	9.20	7.20	11.31	11.63	9.87
	Burundi	14.95	16.60	18.30	13.50	13.50	15.20	16.40
Total Capital to Total Assets								
	Uganda	8.86	10.41	10.39	10.95	10.37	13.23	13.63
	Kenya	11.20	11.75	12.40	11.43	12.80	12.56	13.56
	Tanzania	-	-	6.85	7.62	8.14	8.85	11.62
	Rwanda	8.70	9.00	9.10	8.90	10.38	13.09	5.04
	Burundi	9.25	9.20	8.90	9.00	8.50	9.20	10.20
NPLSs to Total Gross Loans								
	Uganda	7.25	2.19	2.32	2.95	4.11	2.2	4.13
	Kenya	33.43	27.98	24.81	20.19	10.67	8.96	8.85
	Tanzania	-	-	-	6.75	6.32	6.17	7.27
	Rwanda	8.70	9.00	9.10	8.90	10.38	13.09	14.06
	Burundi	21.40	20.10	20.60	18.60	18.80	14.60	15.42
Return on Assets (ROA)								
	Uganda	4.51	4.25	3.55	3.37	3.86	3.54	2.37
	Kenya	2.18	2.05	2.36	2.65	3.04	2.82	3.30
	Tanzania	-	-	3.85	3.85	4.69	3.83	3.95
	Rwanda	2.10	0.60	0.90	1.60	1.70	2.40	5.25
	Burundi	1.40	1.00	1.90	1.70	2.30	2.70	1.00
Return on Equity (ROE)								
	Uganda	43.16	37.81	29.63	28.32	31.41	25.00	15.23
	Kenya	23.65	22.54	25.29	27.15	28.29	25.18	29.47
	Tanzania	-	-	26.26	26.71	28.99	23.25	22.60
	Rwanda	23.70	7.40	11.20	16.50	17.50	18.60	13.75
Total Loans to Total Deposits								
	Uganda	38.35	37.40	48.46	57.50	60.17	72.51	65.72
	Kenya	75.46	81.68	79.26	77.17	70.90	73.28	73.28
	Tanzania	-	-	43.73	50.11	57.64	68.43	66.91
	Rwanda	76.06	67.62	75.58	71.06	63.43	87.83	65.89
	Burundi	93.80	81.80	72.40	74.70	67.20	68.60	67.90

		2003	2004	2005	2006	2007	2008	2009
Foreign Currency Denominated Assets to Total Assets								
	Uganda	30.48	29.42	27.64	29.34	30.11	26.88	27.47
	Kenya	14.35	16.22	15.61	15.37	8.94	9.74	9.74
	Tanzania	-	-	33.38	36.09	29.07	29.04	29.09
	Rwanda	28.20	29.00	25.70	27.00	24.40	19.11	21.10

Source: Central banks of Burundi, Kenya, Rwanda and Tanzania

Note: Data for 2009 is as at March 2009.

Table 3: Selected financial soundness indicators for Uganda's banking system

Indicators (%)	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09
MEASURES OF CAPITAL ADEQUACY									
Regulatory Capital to Risk-weighted Assets	19.43	19.46	21.07	20.46	19.61	20.74	22.04	21.13	21.82
Regulatory Tier 1 Capital to Risk-weighted Assets	17.48	17.77	19.83	19.11	18.19	18.73	20.18	19.29	19.38
Total Capital to Total Assets	10.66	10.37	11.67	11.90	12.30	13.23	13.84	13.42	13.63
MEASURES OF ASSETS QUALITY									
NPLs to Total Gross Loans	3.49	4.11	3.94	4.09	3.68	2.20	3.06	4.03	4.13
NPLs Net of Provisions to Capital	6.25	8.43	5.32	7.00	3.53	1.80	5.09	6.95	6.11
Sectoral Distribution of Loans to Total Loans									
Government	0.04	0.02	0.03	0.59	0.66	0.09	0.08	0.08	0.07
Agriculture	7.84	9.07	9.08	5.99	5.67	6.93	5.38	4.50	5.48
Mining & Quarrying	2.78	0.55	0.37	0.35	0.56	0.83	0.38	0.30	0.40
Manufacturing	15.38	16.75	14.05	12.30	13.36	14.18	15.05	15.15	13.32
Trade & Commerce	15.02	13.53	13.43	12.17	14.62	18.19	19.86	20.60	19.74
Transport	9.13	11.28	9.20	7.70	6.26	6.94	6.84	6.44	6.64
Construction	5.43	5.63	10.13	9.66	11.03	10.93	10.81	11.44	10.13
Personal loans	17.56	16.44	17.65	15.31	25.62	25.71	21.25	21.91	26.20
Real estate	5.13	4.79	5.55	5.37	4.57	6.32	6.13	4.99	6.38
Other services	21.70	21.94	20.51	30.57	17.64	9.87	14.23	14.59	11.64
Large Exposures to Capital	158.23	165.66	121.96	118.67	120.53	104.04	92.51	99.16	93.25
Earning Assets to Total Assets	77.55	80.15	79.31	81.59	80.36	78.98	78.52	80.05	79.88
MEASURES OF EARNINGS & PROFITABILITY									
Return on Assets (ROA)	3.87	3.86	3.33	3.45	3.40	3.54	4.30	3.18	2.37
Return on Equity (ROE)	31.74	31.41	25.23	26.60	25.35	25.00	27.34	20.34	15.23
Interest Margin to Gross Income	52.69	52.10	53.61	50.32	52.87	48.77	52.20		
Non Interest Expenses to Gross Income	46.55	46.31	46.71	49.03	48.59	49.50	47.25	51.93	53.16
MEASURES OF LIQUIDITY									
Liquid Assets to Total Assets	31.10	30.44	32.71	31.17	26.26	29.89	26.88	26.72	27.47
Liquid Assets to Short-term Liabilities	44.09	42.42	48.34	44.64	39.60	45.93	42.29	41.33	43.59
Liquid Assets to Total Deposits	45.86	46.72	50.80	48.22	43.84	48.09	42.27	42.17	43.63
Total Loans to Total Deposits	57.74	60.17	63.34	66.55	75.18	72.51	71.32	69.14	70.39
Borrowings from Central Bank to Total Deposits	0.173	0.000	0.000	0.036	0.000	0.032	0.010	0.009	0.480
MEASURES OF SENSITIVITY TO MARKET RISK									
NOP in Foreign Exchange to Capital	-7.28	-8.43	-9.71	-7.93	-10.74	-1.42	-1.49	-2.67	-0.83
Foreign Currency Denominated Assets to Total Assets	26.74	30.11	27.79	26.95	24.47	26.88	24.88	24.95	22.35
Foreign Currency Denominated Liabilities to Total Liabilities	27.72	30.91	26.27	27.94	27.04	26.17	25.29	22.73	20.55