Bank of Uganda

FINANCIAL STABILITY REPORT

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A note on *Financial Stability*

The Bank of Uganda has a mandate to foster price and financial system 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.

Financial stability analysis involves a continuous assessment of potential risks to the financial system and the development of policies to mitigate these risks. A regular analysis of developments in the financial system is necessary for early detection of risks to the system which in turn is a perquisite to provide policy makers the lead time necessary to take pre-emptive action to avert a crisis.

The publication of the *Financial Stability Report (FSR)* is one way in which the Bank fulfils its mandate. The *FSR* is published twice a year and it highlights 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.

By making the *FSR* available to the public, the Bank aims to stimulate debate on policies necessary to manage and mitigate these risks. 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.

Foreword and Assessment of Financial Stability

This is the second Financial Stability Report of the Bank of Uganda. The report analyses the performance and condition of the Ugandan financial system and evaluates threats to its systemic stability.

The threats to the global financial system have abated during 2010. The global economy has continued its recovery from the impact of the financial crisis in 2007/08, although output growth is still unevenly spread around the world. The combination of economic recovery and policy measures to support financial markets has enabled major international banks to restore profitability and to begin to rebuild their balance sheets.

The East African region has weathered the effects of the global crisis relatively well, because of strong macroeconomic policies in the region and generally sound banking systems which are not dependent on international markets for funding. All of the countries in East Africa recorded positive GDP growth in 2009/10.

The banking system in Uganda remains in a financially sound condition, with a capital adequacy ratio of 22 percent as of June 2010, almost double the statutory minimum. After a dip in performance in 2009, many indicators of the performance of the banking system improved in the first half of 2010. There was an acceleration in the growth of bank assets and deposits. Bank profitability, which had declined in 2009, recovered in the first half of 2010, with returns on both assets and equity increasing. Profitability was boosted by an improvement in asset quality, due to a fall in non performing loans. However, nearly half of the commercial banks reported losses in the first half of 2010, mainly due to rising operating costs, although the market share of the loss making banks is relatively small. The banking system remained highly liquid and the cost of funding in the domestic interbank market declined.

Our overall assessment is that, in the short term at least, there are no major threats to the systemic stability of the Ugandan banking system. Furthermore, the banking sector holds substantial levels of capital and liquidity which provide a buffer against shocks to its balance sheet. Nevertheless, the financial system is evolving rapidly and its risk profile is not static; hence it is essential to monitor closely the condition of the financial system and to remain alert to any threats to its stability which might emerge in the future.

Emmanuel Tumusiime-Mutebile

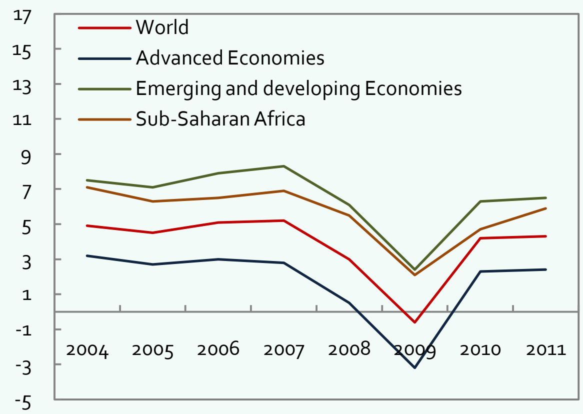
GOVERNOR

1. The International Macrofinancial Environment

Economic recovery around the world has picked up since the last quarter of 2009 although growth is still unevenly spread. However, there are fears that growth in advanced countries is stalling and their economies may face a prolonged period of below trend growth. In contrast, output in a number of emerging countries has been stronger; a trend that is helped by the fact that most emerging and developing economies escaped the brunt of the global financial crisis.

While the East African region has weathered the effects of the crisis better, the main risks facing East African countries remain the stalling of the global economic recovery which would place downward pressure on export growth and increase exchange rate volatility which may affect the profitability of firms.

Chart 1: Annual GDP growth



Source: IMF, World Economic Outlook database April 2010
Notes: 2010 and 2011 figures are forecasts

1.1. The global economic climate

Global output is forecast to increase by 4.5[1] percent in 2010 and 4.3 percent in 2011 following a 0.5 percent contraction in 2009 (Chart 1). Although the outlook for output growth is positive, downside risks still linger due to fears about deflation and depressed consumer demand. The recent turbulence in the financial markets has mainly been stoked by the high levels of debt and fiscal deficit observed in many advanced economies especially in Europe.

1.2. Emerging Market and Developing Economies

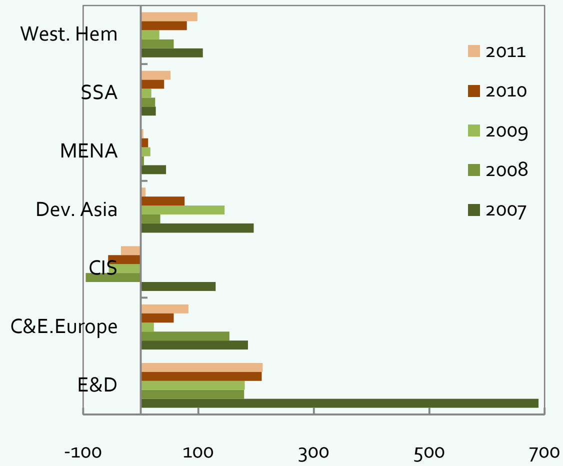
Emerging economies outpaced developed counterparts

Emerging economies have fared much better than their more developed counterparts during and in the aftermath of the crisis. Emerging markets were affected by the financial crisis mainly through a reduction in capital inflows (Chart 2) as investors became risk averse and sought relatively safe assets such as US Treasury securities.

However, the transition economies in Eastern Europe experienced much more severe capital withdrawals than the emerging countries in Asia and Latin America. As conditions in the world economy improved, emerging economies in Asia and Latin America experienced a surge in capital inflows. Their recovery has been faster compared to other regions

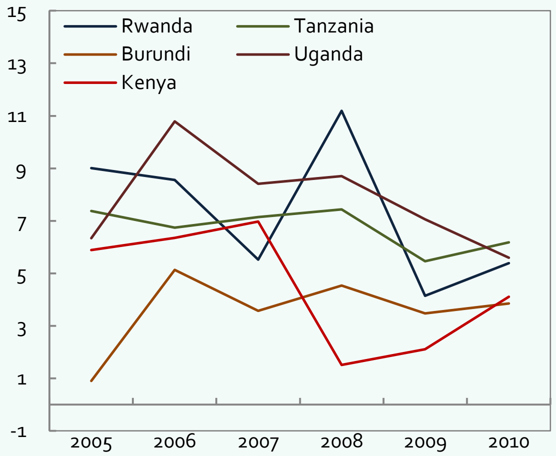
[1] IMF, WEO July 2010 Update

Chart 2: Net Private Financial Flows (Billions of USD)



Notes:
1) E&D, Emerging and Developing countries; C&E, Central and Eastern Europe; CIS, Commonwealth of Independent States; MENA, Middle East and North Africa; SSA, sub-Saharan Africa; Western Hemisphere
2) 2010 and 2011 are projections
Source: IMF, WEO Database, April 2010

Chart 3: Changes in regional GDP growth (*annual percentage changes*)



Notes: 2010 figures are projections
Source: IMF, WEO Database April 2010

mainly due to the strength of domestic demand and, relatively stronger current account and fiscal positions.

Challenges in Emerging economies

A key emerging challenge to financial stability in emerging countries is the increase of capital inflows due to improved investor sentiment and interest rate differential as rates in developed countries remain very low. This could be attributed to the fact that emerging markets are leading the global recovery with a better growth outlook than the US and Europe. Large capital inflows can complicate macroeconomic management given their potential to generate inflationary pressure, and feed credit and asset price boom-and-bust cycles.

Some countries faced with a sudden surge in capital inflows have resorted to capital controls; Brazil levied a 2% tax on foreign purchases of fixed income securities and stocks, while Taiwan banned international investors from placing funds in time deposits in November 2009.

1.3. Developments in the East African region

Output growth slowed

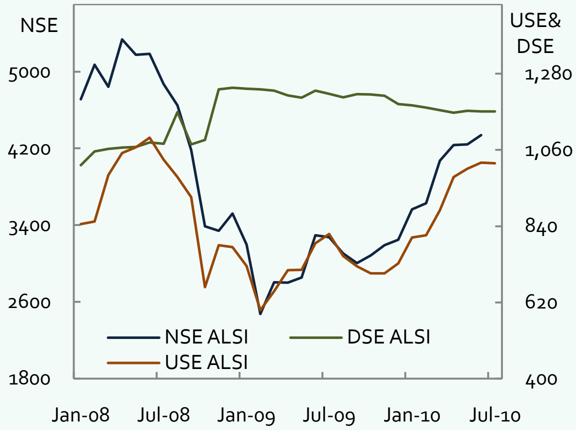
Although all five economies in the East African region registered positive growth (Chart 3) in 2009, year-on-year growth declined compared to 2008 in all EAC countries save for Kenya. The decline in growth could be attributed, in part, to subdued consumer demand and a drop in export earnings owing to the global recession. Uganda has had one of the highest GDP growth rates in the region, but it is estimated to have slowed down to 5.8 percent in fiscal year 2009/10 from 7.2 percent in 2008/09[2]. Kenya's GDP growth on the other hand is projected to increase by a percentage point to 4 percent in 2009/2010 reflecting a recovery from the effects of the political crisis that pulled down growth in 2007/08.

Equity markets

Stock market activity varied across the three regional exchanges. The stock indices in Uganda and Kenya dropped

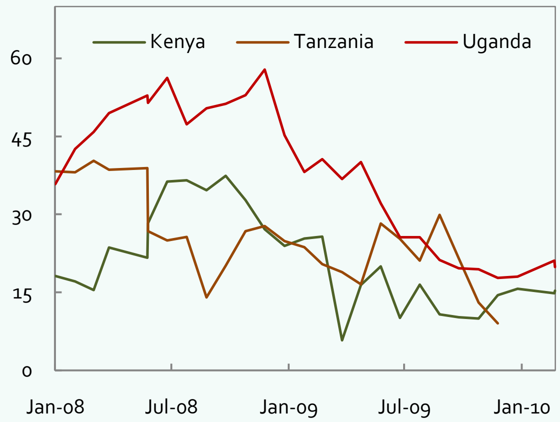
[2] Performance of the Ugandan Economy for the 2009/10 Uganda Bureau of Statistics

Chart 4: Monthly East African stock indices



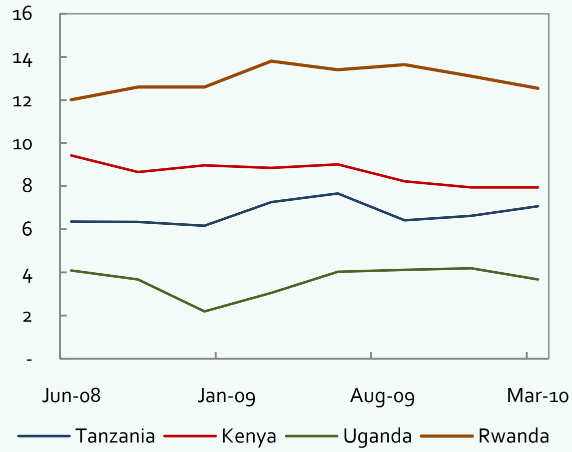
Source: Uganda Securities Exchange, Nairobi Stock Exchange and Dar-es-Salaam Stock Exchange

Chart 5: Year-on-year growth of credit extended to the private sector by banks (*percent*)



Source: Central banks of Kenya, Tanzania, and Uganda

Chart 6: EAC Ratio of non-performing loans to total loans (percent)



Source: Central banks of Kenya, Tanzania, and Uganda

from the highs observed at the beginning of 2008 to reach lows in February 2009. However, they have since recovered from the losses experienced in that period. The Nairobi Stock Exchange All Share Index and the Uganda Securities Exchange All Share Index rose in the first half of 2010 while the Dar-es-Salaam All Share Index fell in the same period (Chart 4).

Credit Growth

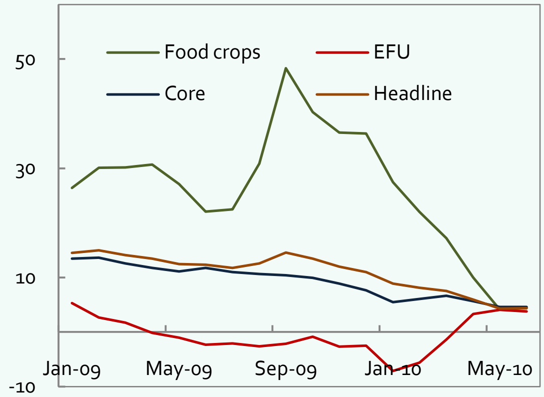
During the global financial crisis, credit markets tightened globally with many financial institutions scaling down credit extensions in order to minimise exposure to credit default resulting from the challenging economic environment. Banks in East Africa continued to lend to the private sector though credit growth was at relatively lower levels compared to those achieved before the onset of the crisis. Data from commercial banks in the region shows that the average rate of annual growth of private sector credit was lower in March 2010 at a regional average of 15.9 percent compared to 28.9 percent in March 2009 (Chart 5).

Financial performance of banks

The ratio of non-performing loans (NPLs) to total gross loans as an indicator of asset quality has remained below 10 percent for all the East African countries except Rwanda since September 2008 (Chart 6, Table 1). However, NPLs to total loans have increased since September 2009 in Tanzania, while the ratio was stable for Kenya and Rwanda there was a slight decrease in Uganda between quarters ending December 2009 and March 2010.

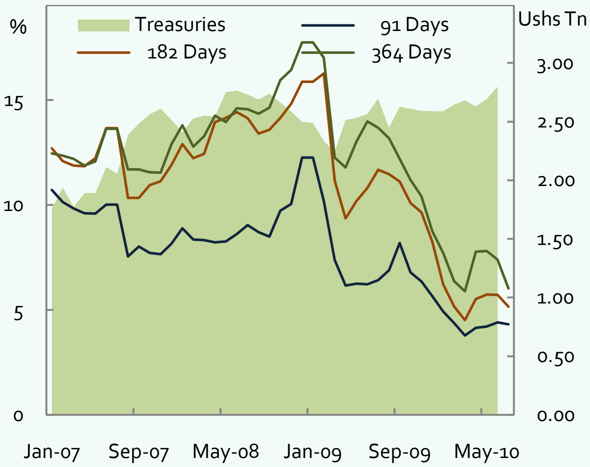
Banks in East Africa have continued to be well capitalised, with the regional capital adequacy ratio remaining stable at 20 percent in March 2010, the same level observed in March 2009. However, banks' profitability in the region has somewhat declined with both average returns on equity and average returns on assets for the banking industry in the region dropping from 23.7 percent and 3.3 percent respectively in March 2009 to 15.2 percent and 2.1 percent in March 2010 (Table 1).

Chart 7: Annual Headline inflation in Uganda (*percent*)



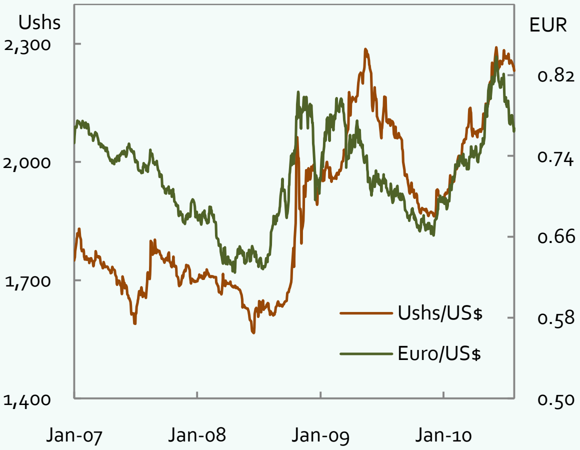
Source: Uganda Bureau of Statistics

Chart 8: Treasury Bill yields (*percent*) and stock (*Ushs Tn*)



Source: Bank of Uganda

Chart 9: Movements of the shilling and euro against the dollar



Source: Thomson Reuters

1.4. Uganda's macrofinancial environment

Uganda's output growth slowed down

Preliminary real Gross Domestic Product (GDP) figures project a growth of 5.8 percent in fiscal year 2009/10, a fall of 1.4 percent from growth in 2008/09. The depressed demand reflected in lower private consumption and exports contributed to the weakening of economic growth.

Inflation dropped back to single digit figures in the first half of 2010. The annual headline inflation for the year to June 2010 went down to 4.4 percent from 12.3 percent in June 2009 (Chart 7). The drop in headline inflation was largely due to decline in core (non-food) inflation, which was caused by weakening consumer demand.

Yields on treasury securities

Average yields for government securities have been dropping since mid 2009 (Chart 8), but the outstanding stock of treasury bills and bonds increased by 9 percent to Ushs.2.8 trillion by the end of June 2010 from the same period last year. Banks hold a substantial part of their assets in Treasury securities and hence the movements in the yields affect bank profitability.

The foreign exchange market

The weakness of the Uganda shilling against the dollar in the first half of 2009 was attributed to, among other things, the rapid exit of offshore portfolio investors combined with weak export earnings. The shilling recovered significantly in the second half of 2009 (Chart 9). However, this trend was reversed in the first quarter of 2010 due, in part, to increased global demand for the U.S dollar as investors continued to shun euro-denominated assets.

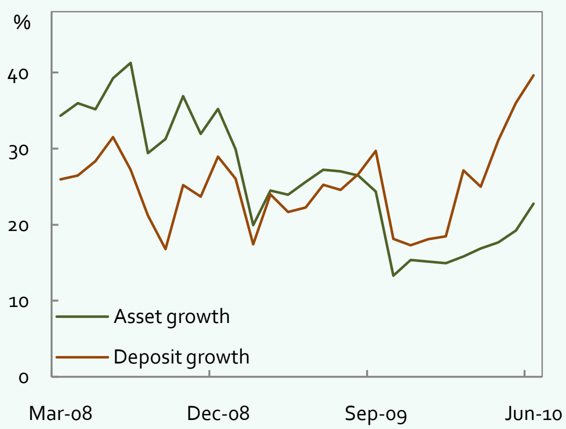
Conclusion

Global economic recovery has continued to pick up driven by the policy measures in place, helping to reduce systemic risks to financial stability. In spite of this, the recovery remains fragile in most advanced economies. Projections point to a relatively slow recovery, which may affect the Ugandan economy through reduced export earnings and tax revenue.

2. Developments in the Banking Industry

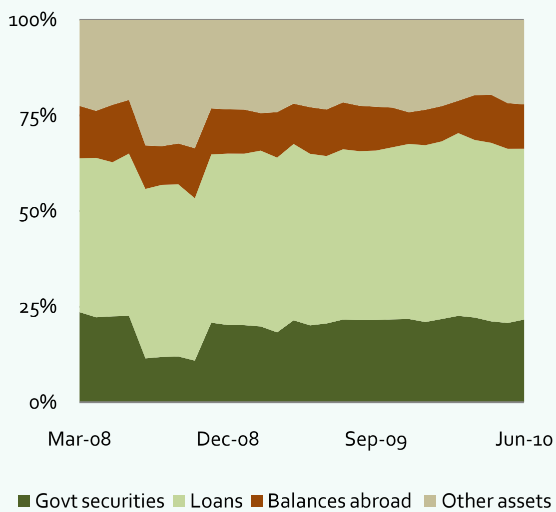
Uganda's banking sector has come through the recent financial crisis well and the outlook for the sector has improved since September 2009. Credit growth has remained subdued, largely on account of low demand and tighter lending standards. However, credit risk has moderated with the ratio of nonperforming loans to total loans reducing during the period reflecting an overall improvement in asset quality. In addition, banks have remained well capitalised with capital well above the regulatory minimum. Bank profitability however remains weighed down by rising operating costs.

Chart 10: Annual growth rate of banks' assets and deposits



Source: Bank of Uganda

Chart 11: Structure of banks' assets



Source: Bank of Uganda

2.1. Growth of the industry

Asset and deposit growth

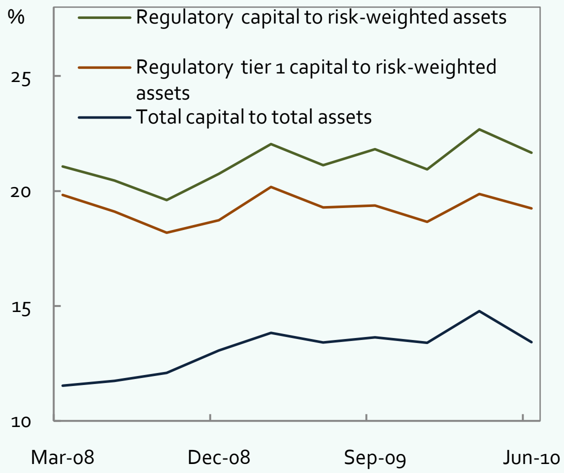
Bank data shows growth in assets and deposits has steadily picked up (Chart 10) since the last quarter of 2009. However, year–on-year growth remains below recent historical trends with assets registering annual growth of only 23 percent in June 2010 compared to 39 percent in June 2008 and 27 percent in June 2009. The high asset growth in 2008 and 2009 could have been due to the entry of new banks. In contrast, annual deposit growth was recorded at 40 percent in June 2010, which is significantly higher than the 31 percent annual growth rate achieved in June 2009.

A review of the structure of banks' assets (Chart 11) reveals that aside from loans which averaged 45 percent of industry assets between June 2008 and June 2010, banks also maintained their holdings of government securities at average of 20 percent of their assets during the same period. In addition, as a percentage of total assets, balances due from non-resident debtors declined from 14 percent to 11 percent during the same period.

2.2. Capital Adequacy

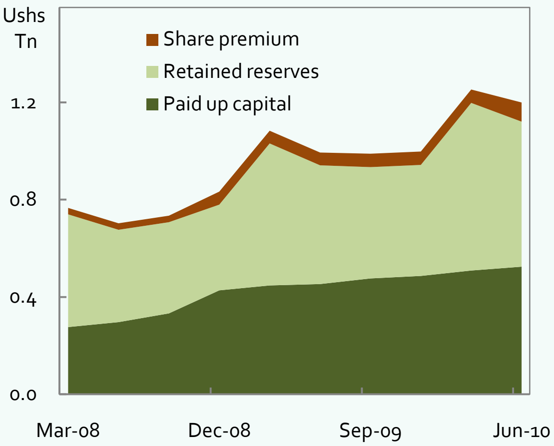
The capital positions of banks remained strong over the year to June 2010. Specifically, the average capital adequacy ratio for the industry remained relatively stable at 21.6 percent as at June 2010 which is significantly higher than the regulatory minimum of 12 percent (Chart 12). During this period, the banking system maintained capital levels that provide them with a sufficient buffer to absorb losses that occur in the

Chart 12: Measures of capital adequacy



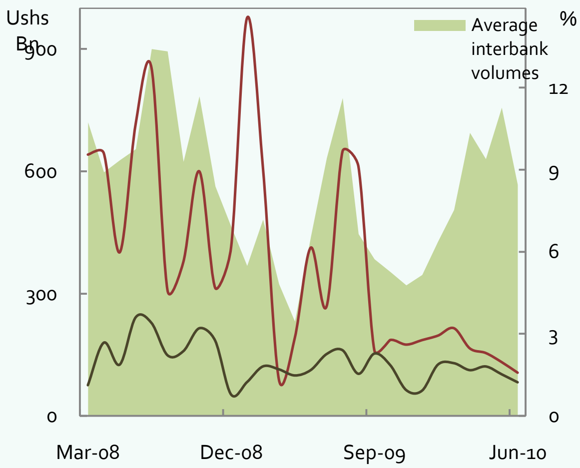
Source: Bank of Uganda

Chart 13: Breakdown of aggregate Tier 1 capital



Source: Bank of Uganda

Chart 14: Monthly interbank activity



Source: Bank of Uganda

normal course of business.

As at June 2010, aggregate Tier 1 capital for the banking sector was Ushs.1.2 trillion, of which Ushs.596 billion was retained earnings and paid-up capital was Ushs.524 billion (Chart 13). Paid-up capital increased because a number of smaller banks received capital injections from their shareholders in the last quarter of 2009.

2.3. Funding conditions and liquidity

Stability in the interbank interest rates

The interest rate volatility that was observed in the interbank market between March 2008 and July 2009 reduced in the period to June 2010 (Chart 14). The overnight and 7-day rates dropped from 4 percent and 8 percent in June 2009 to 2 percent and 3 percent in June 2010, respectively. Chart 14 shows that interbank rates remained low, especially between September 2009 and June 2010.

Sources of funding

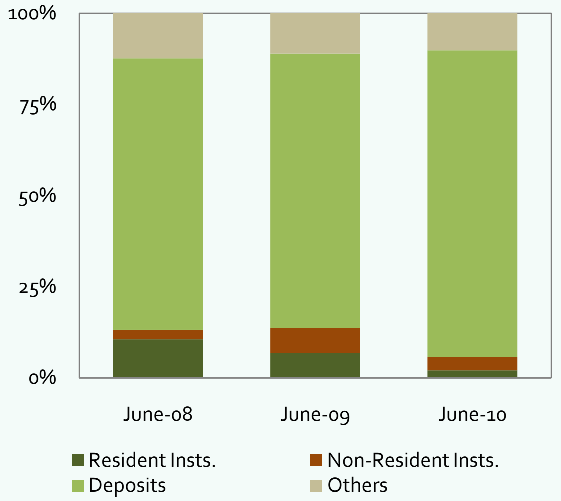
Ugandan banks have traditionally relied on retail deposit mobilisation for the bulk of their funding. This funding structure ensured that at the height of the crisis the banking sector did not experience the funding pressures faced by their counterparts in advanced countries who rely more on wholesale markets for funding.

Other than deposits, banks raised funds through borrowing from financial institutions in Uganda and abroad. Banks' exposure to non-resident institutions as a percent of liabilities halved to 3.6 percent in June 2010 from 6.9 percent in June 2009 (Chart 15).

2.4. Asset quality

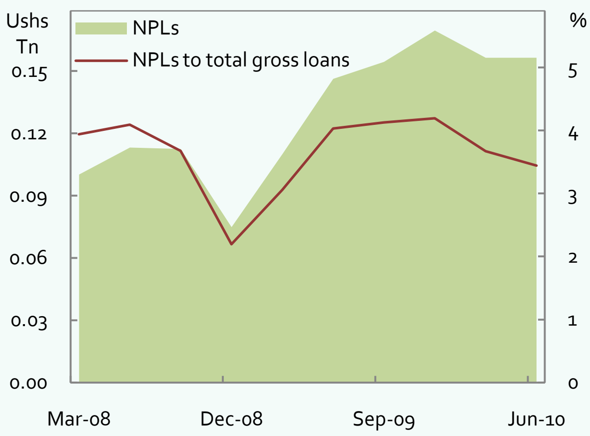
Banks' asset quality deteriorated slightly in the year to June 2010, with the level of non-performing loans (NPLs) increasing to Ushs.156.4 billion in June 2010 from Ushs.146.2 billion in June 2010. However, the first half of 2010 saw an improvement in the movement of non-performing loans;

Chart 15: Sources of bank funding as a share of total liabilities



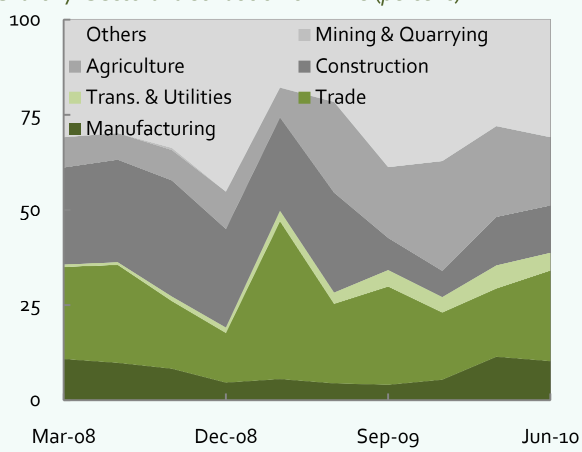
Source: Bank of Uganda

Chart 16: Non-performing loans



Source: Bank of Uganda

Chart 17: Sectoral distribution of NPLs (*percent*)



Source: Bank of Uganda

between December 2009 and June 2010 (Chart 16).

Further, the ratio of NPLs to total gross loans rose steadily during 2009, but fell in the first half of 2010. As a percentage of total lending, NPLs moderated to 3.4 percent in June 2010 after a steady rise to 4.2 percent in December 2009. The reduction in loans classified as non-performing during the second quarter of 2010 was partly due to loans amounting to Ushs.21 billion which were recovered by banks.

NPLs limited to few sectors

The rise in the ratio of NPLs to total gross loans in 2009 was mainly attributed to the agriculture sector (Chart 17). However, at the end of 2009, the largest concentration of agriculture NPLs was limited to a few banks.

As a percentage of total NPLs, NPLs from the agriculture sector amounted to 18 percent in June 2010 which is lower than 24 percent that was recorded in the same month last year. Instead, the trade sector had the highest share of NPLs at 24 percent.

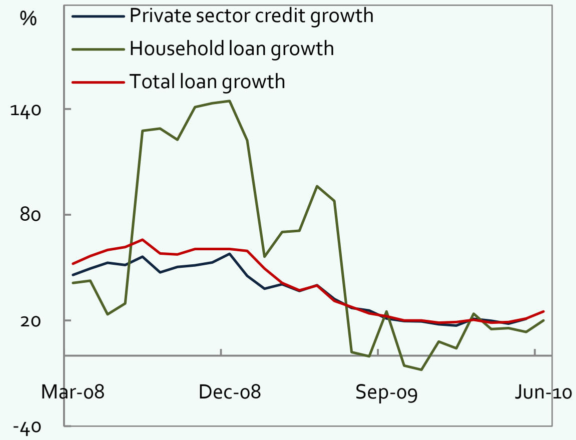
2.5. Credit Extension

In the two years to June 2010, there was a significant slowdown in credit growth as banks focused on repairing loans books. Year-on-year growth in credit to the private sector slowed down to 25 percent in June 2010 compared to 32 percent in June 2009 (Chart 18).

Mortgage lending

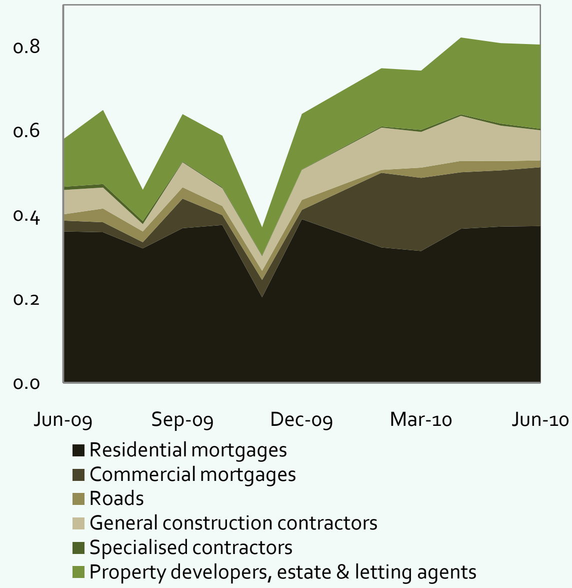
Banks increased their mortgage lending in 2009/10, especially for commercial projects. Between June 2009 and June 2010, total mortgages jumped from Ushs.386 billion to Ushs.513 billion, a rise of 33 percent. In June 2010, 27 percent of mortgages were for commercial properties (Chart 19). The rise in mortgage lending coincides with the growth that has been observed within the construction sector. The downside risk is that credit growth to this sector may feed a bubble which will make the sector vulnerable to the risk of unexpected shocks to property prices.

Chart 18: Year-on-year growth of loans



Source: Bank of Uganda

Chart 19: Banks' mortgage lending (*Ushs Trillions*)



Source: Bank of Uganda

2.6. Earnings and Profitability

The profitability of the banking sector declined for much of 2009 with a 40 percent decline in net after tax profit (Chart 20) for the year ending December 2009. However, there was a marked improvement during the first half of 2010, which registered a rise in nominal profit from Ushs.43 billion in the quarter ending December 2009 to Ushs.72 billion in the quarter ending June 2010.

Banks' earnings were mostly bolstered by net interest income on advances, along with earnings on government securities and customer charges and fees. While this income helped to balance out the rise in expenses, banks were faced with persistently high operational costs particularly in the market segment consisting of new entrants as they expanded their outreach. Operating expenses rose from Ushs.121 billion to Ushs.198 billion in the two years to June 2010, pushing the cost-to-income ratio from 69 percent to 76 percent in this period (Chart 21).

The return on average assets (ROA) and return on average equity (ROE) for the industry declined during 2009; following peaks in December 2008. ROA and ROE slid to 2 percent and 13 percent respectively in December 2009. As at end June 2010, ROA and ROE ratios improved to 3 percent and 20.2 percent respectively (Chart 22).

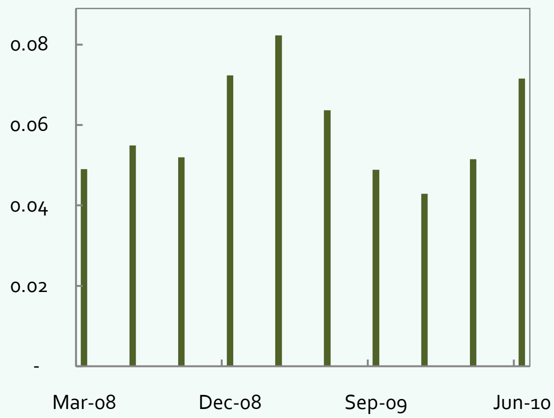
Banks' interest rates exhibited slight volatility for much of 2009. The average lending rate reduced slightly to 20 percent in June 2010 from 22 percent in June 2009. Similarly, banks' average rates paid out on deposits dropped from 2.4 percent to 1.9 percent in the same period.

2.7. Exposure to Market Risk

Foreign currency exposure

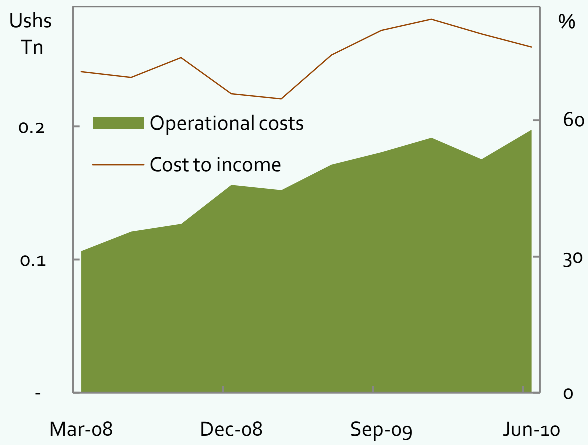
Bank's foreign exchange exposure rose slightly with the ratio of foreign currency exposure to regulatory Tier 1 capital increasing from 2.9 percent in June 2009 to 3.5 percent in

Chart 20: Quarterly net profit after tax (*Ushs Trillions*)



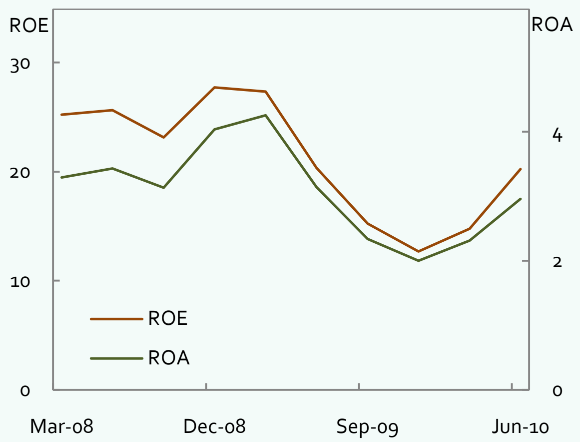
Source: Bank of Uganda

Chart 21: Breakdown of banks' costs and income



Source: Bank of Uganda

Chart 22: Measures of banks' profitability (*percent*)



Source: Bank of Uganda

June 2010 which however, is well within the regulatory minimum. In addition, the ratio of foreign currency assets to foreign currency liabilities decreased from 109.8 percent in June 2009 to 98.4 percent in June 2010 (Table 4).

Conclusion

In the period leading up to our last *Report*[3], conditions in the banking industry had become challenging. The period of weak economic performance in 2009 had translated into weaker asset growth over 2009. In addition, deposit growth dipped significantly in the last half of 2009. These trends also affected banks' performance in terms of earnings and profitability, asset quality and credit growth.

Since January 2010 however, most indicators of bank performance have improved from downward trends observed before. In addition, annual asset and deposit growth have picked up from the December 2009 level. Banks remain well capitalised with their efforts to boost profits supported by a fall in non-performing loans.

The banking system, although showing promising signs of improved growth, will continue to face some challenges. First, interest income is likely to be affected by a fall in interest margins given the declining yields from government securities as well as increased competition in retail lending. Secondly, operating costs have shown an upward trend and banks need to take steps to reduce these expenses.

[3] Bank of Uganda, Financial Stability Report, December 2009

3. Proposals by the Basel Committee on Banking Supervision to strengthen the resilience of the banking sector: Discussion and Implications

The financial crisis of 2007-09 led to a number of proposals at the global level aimed at enhancing the resilience of the financial system and strengthening the regulatory framework. In December 2009, the Basel Committee on Banking Supervision (BCBS) issued for consultation, a package of proposals for strengthening global capital and liquidity regulations with the goal of promoting a more resilient international banking sector. In September 2010, the Group of Governors and Heads of Supervision, the oversight body of the BCBS approved the reforms. This section provides a summary of these new regulations as well as the possible effect of these reforms on the banking sector in Uganda.

3.1. Background

While Uganda, like most African countries, adopted the Basel I capital adequacy framework for bank capital regulation, most advanced economies have moved on to Basel II. However, following the recent global financial crisis the efficacy of the Basel accords became increasingly questioned, with inquiries focusing on whether the Basel capital accords are pro - cyclical (ECB 2009) and also criticised for encouraging regulatory arbitrage, thereby contributing to the build up of systemic risks in the financial system. The financial crisis of 2008/09 generated the impetus for reforms to the regulatory framework to strengthen banking systems and improve their resilience to shocks. Overtime, it has also become clear that such reforms have not only to address the regulation of banks, but also to encapsulate other elements of the financial system that pose systemic risk.

In response to the above issues, in late 2009, the BCBS issued consultative papers: *"Strengthening the resilience of the banking sector"; and "International framework for liquidity risk measurement, standards and monitoring".*

3.2. A summary of the reforms

The key elements of the reforms the BCBS issued are the following:

a) Capital Regulations
- *Raising the quality, consistency and transparency of the capital base*
- *Enhancing the risk coverage of capital*
- *Implementing a leverage ratio*
- *Reducing pro-cyclicality and promoting countercyclical capital buffers*
- *Addressing systemic risk and interconnectedness*

b) Liquidity Regulations
- *Enhancement of liquidity risk measurement, standards and monitoring*

The Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision, approved a number of the reforms in September 2010, setting a stricter definition of capital and higher global minimum standards, enhancing risk coverage and introducing a global liquidity standard. At the same time, national implementation by member countries will begin on January 1 2013 and be phased until 2018. From 2013, banks will be required to meet the following new minimum requirements relative to risk weighted assets (RWAs); 3.5 percent common equity/RWAs; 4.5 percent Tier 1 capital/RWAs; and

8.0 percent Total capital/RWAs. These changes form the core of the global financial reform agenda.

3.3. Discussion and implication of the reforms and other proposals

Raising the Quality, Consistency and Transparency of the Capital Base

The BCBS has set new standards aimed at raising the quality, consistency and transparency of bank's capital base, with three main areas of focus. First, the predominant part of Tier 1 capital for banks will be composed of common shares and retained earnings. The objective is to improve the quality of capital by increasing the portion of tangible common equity in capital from the current 2 percent level to 4.5 percent by 1 January 2015 and thereby ensure 'that large, internationally active banks are in a better position to absorb losses on both a going concern and gone concern basis' (BCBS 2009). In addition, the Tier 1 capital requirement, which includes common equity and other qualifying financial instruments, will increase from 4 percent to 6 percent by January 1 2015.

Second, the reforms aim to simplify and harmonise the list of regulatory adjustments to capital and their treatment across all jurisdictions. Stock surpluses (share premiums), minority interests, pension fund assets, deferred tax assets, goodwill and other intangibles, and the shortfall of provisions to expected losses will be excluded from Tier 1 capital, ensuring consistency of the regulatory capital base.

Third, the proposals will require more detailed public disclosures of regulatory capital bases. To enhance transparency of bank capital and promote market discipline, banks will be required to disclose clearly all components of capital, and provide a reconciliation of regulatory capital elements back to the audited financial statements.

The requirement that Tier 1 capital should be composed predominantly of common shares and retained earnings will have little effect on Ugandan banks, since this is already the norm. Also the Ugandan Capital Regulations issued under the Financial Institutions Act, 2004 already require that goodwill and other intangible assets, minority interests, and deficiencies in provisions to be deducted from Tier 1 capital. This is in line with Basle I recommendations which Uganda is currently implementing. The ratio of Tier 1 capital to risk weighted assets for Ugandan banks was 19.2 percent at end June 2010, far above the new requirement of 6 percent.

Enhancing the Risk Coverage of Capital

A key message from the financial crisis was the need to strengthen risk coverage of the Basel II framework. In this regard, the BCBS, in July 2009 issued trading book exposure and securitisation reforms aimed at raising capital requirements for trading book and complex securities exposures. Building on those measures, the BCBS's new reforms are directed at strengthening the capital requirements for counterparty credit risk (CCR) exposures arising from derivatives, repos, and securities financing activities. These enhancements are designed to cover the areas of risk not covered by the current Basel framework. It is envisaged that higher capital requirements for trading, derivative and securitisation activities will be introduced at the end of 2011.

The types of activities covered by the BCBS reforms are not currently widespread in Uganda's banking system. For instance derivative trading is still nascent. Nonetheless, the Bank of Uganda will soon introduce a capital charge for market risk in line with Basle I requirements.

Reducing Procyclicality and promoting countercyclical Capital buffers

The procyclicality of financial and economic shocks across the financial system was one of the most destabilizing elements of the recent financial crisis. The BCBS has introduced three measures to address procyclicality and provide additional shock absorbers in the financial system (BCBS, 2009).

First, the BCBS seeks to promote stronger provisioning practices by advocating a change in accounting standards towards the adoption of a forward looking provisioning approach which takes into account the expected losses in a bank's asset portfolio rather than the current incurred loss model[4].

Second, the BCBS has introduced measures to conserve capital and promote the build up of capital buffers in good times that can be drawn upon during periods of stress. It has been agreed that banks will be required to create and hold a capital conservation buffer above the regulatory minimum requirement calibrated at 2.5 percent, which will be met with common equity. Banks will build up a buffer in 'good times' outside periods of economic stress, which can then be drawn down and used to absorb looses during periods of financial and economic stress (e.g. recessions). The proposals envisage capital distribution constraints (e.g. through limits on payment of dividends and bonuses), which will increase the closer a bank's capital levels get to the minimum[5].

Third, to supplement the buffer mechanism above, the BCBS also has agreed to a macro-prudential approach that would adjust the capital buffer ranges to counteract excessive credit growth. A countercyclical capital buffer within a range of 0 - 2.5 percent of common equity will be implemented at the discretion of national regulators. This buffer, which is largely an extension of the conservation buffer, will be in effect during periods of excessive credit growth leading to a build up of systemic risk. It will provide additional capital to support losses arising from the excessive growth of credit as well as discourage banks from expanding their loan portfolios at an excessive rate, in effect dampening risk.

The Bank of Uganda will study these proposals to determine the best way to operationalise them, particularly the creation of the capital buffers in future, and ensuring that asset provisioning is forward looking. However, while a countercyclical capital framework will contribute to a more stable banking system, capital buffers may not be sufficient by themselves to constrain procyclical credit growth in Africa, because as shown in Table 2, within East Africa, banks already hold, in aggregate, much higher capital levels than the regulatory minimum.

[4] *Incurred losses, which are related to the performing status of the loan, tend to fall in an economic upturn because borrowers can more easily service their loans, but rise sharply during an economic downturn. Hence provisioning based on incurred losses becomes procyclical.*

[5] *The banking regulations in many African countries including Uganda already prohibit the declaration of dividends in specific circumstances.*

Figure 1: Capital Levels in East African countries

Country	Min statutory capital/asset (percent)	Total capital/ asset (percent)	Tier 1 capital/asset (percent)
Burundi	10	18.6	16.4
Kenya	8	19.5	17.3
Rwanda		12.4	12.3
Tanzania	12	18.4	17.9
Uganda	12	20.9	18.7

Source: EAC Statistics March 2010

Implementing a Leverage Ratio

One of the sources of the financial crisis and its severity was the gradual build-up of excessive on and off-balance sheet leverage by financial institutions in many countries. To address these risks and complement the capital requirements outlined above, the BCBS also agreed to introduce a leverage ratio. The ratio is non risk based and will be based on defined capital and total exposure or asset measures and in addition, off-balance sheet items will be appropriately integrated.

The objective of introducing the leverage ratio is to reduce the build-up of leverage in the banking system, diminish the negative effects of the deleveraging processes, and introduce additional safeguards against model risk and measurement errors by supplementing and reinforcing the risk-based capital requirements with a simple, transparent measure of leverage.

In the interim, it has been agreed to test a minimum Tier leverage ratio of 3 percent during a parallel run period from 2013 to 2017, although bank disclosure will begin in 2015. While the regulatory level of the leverage ratio is yet to be concretised, its full effect on the Ugandan banking system is likely to be low because Ugandan banks already hold a high ratio of capital to assets which was 13.4 percent at June 2010, much higher than the level of 3 percent required to meet the international leverage ratio.

Addressing Systemic Risk and Interconnectedness

In times of stress, the interconnectedness of systemic institutions together with array of complex transactions involved, transmits and amplifies negative shocks across the financial system and the economy. The BCBS is seeking to develop macroprudential regulations to reduce risks related to the interconnectedness of financial institutions and markets within the financial system.

To this effect, the BCBS is reviewing the need for additional capital, liquidity or other supervisory measures to reduce the externalities created by systemically important institutions. The BCBS's work in this area is part of a broader effort by the Financial Stability Board (FSB) to address the risks of systemically important financial institutions. More detailed proposals will be issued during 2010.

Liquidity Risk Measurement, Standards and Monitoring

The market turmoil that began in mid-2007 re-emphasized the importance of liquidity to the functioning of financial markets and the banking sector. In advance of the turmoil, asset markets were buoyant and funding was readily available at low cost. The reversal in market conditions illustrated how quickly liquidity can evaporate and that illiquidity can last for an extended period of time. In many countries, the banking system came under stress, which necessitated action by the central banks to support both the functioning of money markets and some individual institutions.

To elevate the resilience of internationally active banks to liquidity stresses across the globe, as well as harmonise international liquidity standards, the BCBS proposed standards in its second consultative document, *'International Framework for Liquidity Risk Measurement, Standards and Monitoring'* in December 2009[6], which were also recently approved.. These standards establish *minimum* levels of liquidity for internationally active banks and complement the BCBS's qualitative '*Principles for Sound Liquidity Risk Management and Supervision*' issued in September 2008. As under the Basel Accord (for capital adequacy), national authorities are free to adopt arrangements that set higher levels of minimum liquidity.

The reforms on liquidity risk achieve two separate but complementary objectives. The first objective is to promote short-term resilience to liquidity disruptions by ensuring that banks have sufficient high quality liquid assets to survive an acute stress scenario lasting for 30 days. The BCBS has proposed the Liquidity Coverage Ratio (LCR) to achieve this objective. The second objective is to promote resilience over longer time horizons by creating additional incentives for banks to fund their activities with more stable sources of funding and reduce liquidity mismatches on an ongoing structural basis. The Net Stable Funding Ratio (NSFR) has been developed to capture longer term structural liquidity issues related to funding choices. The framework also provides a set of monitoring metrics to enable regulators indentify and analyse system-wide liquidity risk trends. The LCR will be introduced in 2015 and the NSFR by 2018. In the meantime, the BCBS is working to introduce a reporting mechanism for these ratios.

[6]*The standards also respond to recommendations of the G20 that called for the BCBS to "….enhance tools, metrics and benchmarks that supervisors can use to assess the resilience of banks' liquidity cushions and constrain any weakening in liquidity maturity profiles, diversity of funding sources, and stress testing practices".*

The Uganda Liquidity regulation requires banks to keep liquid assets not less than 20 percent of deposit liabilities. The liquidity stress tests recommended by BCBS assume deposit withdrawals ranging from 7.5 percent to 100 percent for various categories of liabilities. The banks in Uganda are mainly funded by retail deposits which BCBS assumes will reduce by between 7.5 percent and 15 percent over a 30 day period in time of stress.

Given the lessons learned from the crisis, the proposed common international measurement framework for liquidity risk and the imposition of minimum standards are very relevant to Uganda and other East African countries by providing a consistent benchmark to evaluate bank liquidity.

Conclusions

A sound and resilient financial system is the basis for sustainable economic growth, since banks are central to the credit intermediation process. Given the scope and speed with which the current and previous crises have been transmitted around the globe, it is critical that Uganda, joins other countries, to raise the resilience of its banking sector to both internal and external shocks, and addresses evolving challenges.

The reforms introduced by the Basel Committee including a stricter definition of capital, enhanced risk coverage and the introduction of a global liquidity standard will improve the resilience of the financial sector and help to support global economic recovery. They also provide a suitable opportunity to re-evaluate and where necessary reform bank regulatory policies in Uganda for two reasons; First, to meet the challenges posed by the increasing depth and sophistication of the banking sector, and secondly, to rectify deficiencies in regulation particularly by refocusing towards macroprudential regulation by recognising the systemic nature of risks to financial system stability. The challenge is to develop and implement macroprudential regulations that can effectively dampen systemic risk in the financial sector, complimented by rigorous microprudential supervision, especially for systemically important banks.

The Bank of Uganda will continue to assess the feasibility of the proposals by the Committee for Ugandan banks. The proposed changes, if properly reviewed and calibrated, could promote a banking sector that is less leveraged, less procyclical and more resilient to system wide stress.

References

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Table 1: Selected financial soundness indicators EAC countries (percent)

		8-Sep	8-Dec	9-Mar	9-Jun	9-Sep	9-Dec	10-Mar
Regulatory Capital to Risk-Weighted Assets	Uganda	19.61	20.74	22.04	21.13	21.82	20.95	22.68
	Kenya	18.19	18.87	-	-	-	19.58	20.49
	Tanzania	15.38	14.55	20.42	19.53	19.27	17.99	20.17
	Rwanda	-	15.9	19.07	19.34	20.47	19.02	18.07
NPLS to Total Gross Loans	Uganda	3.68	2.2	3.06	4.03	4.13	4.2	3.67
	Kenya	8.66	8.96	8.85	9.01	8.23	7.94	7.95
	Tanzania	6.34	6.17	7.27	7.67	6.42	6.63	7.07
	Rwanda	-	12.6	13.8	13.4	13.64	13.1	12.55
Return on Assets (ROA)	Uganda	3.13	4.04	4.25	3.14	2.34	2	2.36
	Kenya	3	2.8	-	-	-	2.9	3.7
	Tanzania	3.77	3.82	3.95	3.61	3.41	3.23	2.7
	Rwanda	-	2.36	1.57	0.91	1	0.74	-0.19
Return on Equity (ROE)	Uganda	23.15	27.72	27.34	20.34	15.23	12.69	14.28
	Kenya	29.5	25.18	-	-	-	24.8	32.43
	Tanzania	22.67	23.24	22.61	21.13	20.65	18.54	15.43
	Rwanda	-	18.54	11.37	6.36	7.05	4.97	-1.45
Foreign Currency Denominated Assets to Total Assets	Uganda	24.89	27.21	25.15	25.27	22.67	22.97	26.12
	Kenya	9.03	9.74	-	-	-	8.11	9.37
	Tanzania	26.84	29.04	29.09	29.28	27.75	28.41	27.73
	Rwanda	-	19.52	20.23	20.26	19.5	20.03	19.52

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

Table 2: 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	Mar-10	Jun-10
Capital Adequacy										
Regulatory capital to risk-weighted assets	21.07	20.46	19.61	20.74	22.04	21.13	21.82	20.95	22.68	21.67
Regulatory tier 1 capital to risk-weighted assets	19.83	19.11	18.19	18.73	20.18	19.29	19.38	18.67	19.87	19.25
Total capital to total assets	11.53	11.75	12.10	13.07	13.84	13.42	13.63	13.41	14.97	13.43
Asset quality										
NPLs to total gross loans	3.94	4.09	3.68	2.20	3.06	4.03	4.13	4.20	3.67	3.44
NPLs to total deposits	2.49	2.73	2.76	1.59	2.18	2.79	2.90	3.01	2.49	2.13
Sectoral distribution of loans										
Agriculture	9.07	6.03	5.71	6.93	5.38	4.50	5.49	5.17	6.06	6.45
Mining and quarrying	0.37	0.35	0.57	0.83	0.39	0.30	0.40	0.24	0.15	0.83
Manufacturing	14.04	12.37	13.45	14.20	15.07	15.17	13.33	12.81	13.26	13.63
Trade	13.42	12.24	14.72	18.20	19.88	20.62	19.76	21.66	19.37	19.17
Transport and communication	7.96	6.89	5.54	6.21	6.16	5.81	5.88	7.42	8.14	7.79
Electricity and Water	1.24	0.85	0.76	0.74	0.68	0.63	0.76	0.65	0.68	1.16
Construction	10.25	9.72	11.10	10.94	10.81	11.45	10.13	9.91	18.10	18.62
Personal loans	17.64	15.40	25.79	25.73	21.26	21.93	26.22	23.41	21.90	21.19
Others	26.03	36.15	22.35	16.21	20.37	19.60	18.03	18.72	12.35	15.32
Large exposures to total capital	121.96	118.67	120.53	106.93	92.50	99.16	93.25	111.22	128.74	117.71
Earnings & profitability										
Return on assets	3.29	3.43	3.13	4.04	4.25	3.17	2.36	2.02	2.36	2.96
Return on equity	25.23	25.65	23.15	27.72	27.34	20.34	15.23	12.69	14.77	20.23
Net interest margin	10.35	9.74	10.43	11.31	11.27	10.67	10.09	10.17	10.02	9.84
Cost of deposits	3.25	3.03	3.05	2.49	3.28	3.32	4.02	3.87	3.46	3.08
Cost to income	70.69	69.38	73.76	65.79	64.68	74.34	79.76	82.23	78.98	76.16
Overhead to income	46.71	49.03	48.93	49.50	47.25	51.93	53.16	56.51	50.59	54.57
Liquidity										
Liquid assets to total deposits	50.80	48.22	43.84	48.09	42.27	42.17	43.63	44.67	45.47	41.55
Total loans to total deposits	63.34	66.55	75.18	72.51	71.32	69.14	70.39	71.73	67.76	61.80
Market Sensitivity										
Foreign currency exposure to regulatory tier 1 capital	(9.71)	(7.93)	(10.74)	(1.42)	(1.49)	(2.93)	(0.93)	(0.70)	(2.95)	(3.48)
Foreign currency loans to foreign currency deposits	58.39	56.82	68.77	65.51	57.53	57.29	53.26	57.85	59.24	52.11
Foreign currency assets to foreign currency liabilities	105.77	96.44	90.53	102.72	98.41	109.77	108.72	106.96	101.12	98.42

Source: Bank of Uganda

Table 3: Commercial Bank's aggregated Balance Sheet

	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10
ASSETS (Ushs. Billion)										
Cash & cash assets	268.79	219.65	235.34	337.38	323.77	356.88	330.38	401.5	395.1	453.32
Balances with BOU	393.64	414.16	371.48	462.67	604.22	487.91	533.98	623.56	587.64	917.14
Due from commercial banks	981.76	1,076.32	902.07	1,026.82	1,165.91	1,280.61	1,170.74	1,016.60	1,336.34	1,414.37
Government securities	1,487.00	1,469.25	1,499.49	1,532.44	1,457.98	1,704.50	1,816.90	1,832.27	2,031.85	2,196.24
Total gross loans & advances	2,541.97	2,762.37	3,057.22	3,404.78	3,593.35	3,624.63	3,741.70	4,038.87	4,260.87	4,538.97
LESS: Provisions	-78.34	-82.9	-112.24	-90	-82.86	-105.09	-121.7	-135.24	-117.31	-102.47
Net loans & advances	2,463.63	2,679.47	2,944.98	3,314.78	3,510.49	3,519.55	3,620.00	3,903.63	4,143.56	4,436.50
Net fixed assets	258.76	280.97	335.54	376.06	401	446.67	448.14	472.92	334.68	342.8
Other Assets	378.58	280.87	387.01	414.62	377.66	372.03	400.15	344.22	313.49	394.75
TOTAL ASSETS	**6,232.17**	**6,420.69**	**6,675.91**	**7,464.77**	**7,841.04**	**8,168.15**	**8,320.29**	**8,594.70**	**9,170.59**	**10,155.12**
LIABILITIES (Ushs. Billion)										
Deposits	4,013.51	4,150.57	4,066.66	4,695.57	5,038.65	5,242.46	5,315.94	5,630.54	6,287.95	7,344.75
Due to financial institutions	497.43	556.4	724.62	680.8	576.39	639.3	616.5	602.86	388.42	381.73
Administered funds	202.87	184.64	279.75	323.71	306.37	321.93	297.1	279.23	475.29	230.6
Other liabilities	660.11	673.69	662.97	618.26	657.24	722.33	765.89	701.06	609.96	775.18
TOTAL LIABILITIES	**5,373.92**	**5,565.30**	**5,734.00**	**6,318.34**	**6,578.65**	**6,926.03**	**6,995.43**	**7,213.70**	**7,761.62**	**8,732.25**
CAPITAL (Ushs. Billion)										
Paid-up capital	275.37	295.79	331.68	426.53	446.65	452.34	475.46	485.77	508	523.77
Share premium	26.48	26.77	26.66	53.6	52.31	52.57	55.11	55.11	55.11	78.93
Retained reserves	463.72	379.8	375.22	352.52	584.04	488.45	457.99	456.67	689.44	596.54
Other reserves/surbodinated debt	43.65	49.84	52.57	83.38	97.11	103.45	140.37	147.34	104.94	102.12
Profit – Loss (current year)	49.03	103.2	155.79	230.39	82.27	145.3	195.93	236.11	51.48	121.51
TOTAL SHAREHOLDERS' FUNDS	**858.24**	**855.4**	**941.91**	**1,146.43**	**1,262.38**	**1,242.12**	**1,324.86**	**1,381.00**	**1,408.97**	**1,422.87**
OFF BALANCE SHEET ITEMS (Ushs. Billion)										
Letters of Credit	173.87	170.03	179.63	212.82	241.83	241.04	196.38	201.92	230.97	293.26
Guarantees & performance bonds	329.22	366	367.49	380.45	377.48	412.38	457.75	520.55	519.36	678.76
Unused loans/overdrafts commitment	271.32	217.68	231.25	234.65	207.34	260.92	271.03	318.14	480.71	519.76
Other off balance sheet items	93.36	78.52	277.46	79.37	86.72	149.82	172.16	147.2	-30.71	636.67
TOTAL OFF BALANCE SHEET ITEMS	**867.77**	**832.23**	**1,055.83**	**907.28**	**913.36**	**1,064.16**	**1,097.31**	**1,187.81**	**1,200.33**	**2,128.45**

Source: Bank of Uganda

Table 4: Commercial bank's aggregated income statement

	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10
INCOME (Ushs. Billion)										
Interest income										
Advances	103.81	108.35	125.94	146.07	162.62	168.15	176.98	182.65	186.38	193.56
Government securities	33.65	36.53	33.85	37.03	39.31	38.31	40.82	47.95	47.02	43.62
Deposits abroad	9.39	6.35	6.66	5.36	3.92	2.22	3.65	2.56	2.41	2.72
Other	12.55	15.2	15.09	17.13	15.68	17.26	18.35	6.79	9.18	11.86
Charges, fees & commissions	36.54	39.9	47.33	46.54	50.85	50.95	57.17	59.04	57.61	47.03
Foreign exchange income	25.83	30.17	20.82	52.47	33.55	37.94	32.01	26.78	30.33	37.87
Other income	6.18	10.58	9.77	10.91	16.32	15.19	10.97	13.29	14.08	26.34
TOTAL INCOME	**227.95**	**247.07**	**259.46**	**315.52**	**322.24**	**330.01**	**339.96**	**339.06**	**347.02**	**362.99**
EXPENSES (Ushs. Billion)										
Interest expense on deposits	-31.01	-30.96	-31.29	-27.22	-39.86	-42.61	-53.08	-52.97	-51.51	-52.47
Other interest expenses	-6.18	-11.14	-14.31	-24.52	-13.46	-13.1	-20.4	-15.9	-13.45	-12.96
Provisions for bad debts	-17.47	-8.16	-18.83	0.32	-2.86	-18.21	-16.93	-18.33	-33.56	-12.88
Salaries, wages, staff costs	-44.58	-52.41	-53.83	-62.87	-64.14	-70.17	-72.51	-78.03	-75.13	-81.47
Premises, depreciation, transport	-23.74	-25.84	-29.33	-31.89	-33.93	-36.68	-39.23	-34.43	-38.73	-41.79
Other expenses	-38.14	-42.9	-43.79	-61.41	-54.19	-64.54	-69	-79.15	-61.57	-74.37
TOTAL EXPENSES	**-161.13**	**-171.41**	**-191.38**	**-207.59**	**-208.44**	**-245.31**	**-271.14**	**-278.81**	**-273.95**	**-275.93**
ADD: Extraordinary credits/charges	-	-	-	-	-	-	-	-	-0.13	-0.26
Net profit before tax	66.82	75.66	68.08	107.94	113.8	84.7	68.82	60.25	72.94	86.8
ADD: Corporation tax	-17.79	-20.72	-16.06	-35.57	-31.49	-21.03	-19.94	-17.33	-21.43	-15.21
NET PROFIT AFTER TAX	**49.03**	**54.94**	**52.02**	**72.36**	**82.31**	**63.67**	**48.88**	**42.92**	**51.51**	**71.59**

Source: Bank of Uganda

Abbreviations

BCBS	Basel Committee on Banking Supervision
BoU	Bank of Uganda
EAC	East African Community
ECB	European Central Bank
EEM	Emerging markets
EU	European Union
EUR	The Euro currency
FIA	Financial Institutions Act
FSB	Financial Stability Board
FSR	Financial Stability Report
GBP	Great Britain Pound
IMF	International Monetary Fund
LCR	Liquidity Coverage Ratio
LIBOR	London Interbank offered rate
NPLs	Non-performing loans
NSFR	Net Stable Funding Ratio
ROA	Return on assets
ROE	Return on equity
USD	United States Dollar
Ushs	Uganda Shilling
VIX	Volatility Index
WEO	World Economic Outlook