Bank Of Uganda

FINANCIAL STABILITY REPORT

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Glossary

ALSI	All Shares Index
BCBS	Basle Committee on Banking Supervision
DIR	Debt service-to-income ratio
EAC	East African Community
EMEs	Emerging market economies
FSI	Financial Services Index
FSR	Financial Stability Report
GDP	Gross domestic product
IMF	International Monetary Fund
LCR	Liquidity coverage ratio
NPLs	Non-performing loans
NSE	Nairobi Stock Exchange
RHS	Right hand side
ROA	Return on assets
ROE	Return on equity
UBOS	Uganda Bureau of Statistics
UGX	Uganda shilling
USE	Uganda Securities Exchange
USD	US dollar

A NOTE ON FINANCIAL STABILITY

The Bank of Uganda has a mandate to foster macroeconomic 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 systemic 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. The early detection of risks to the financial system is necessary to give policy makers sufficient lead-time to take pre-emptive action to avert a systemic crisis.

The *Financial Stability Report (FSR)* is intended to enhance 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 risks to the financial system. 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 policy reforms to strengthen the resilience of the financial sector.

FOREWORD AND ASSESSMENT OF FINANCIAL STABILITY

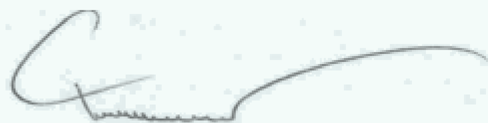
The Bank of Uganda's *Financial Stability Report* analyses the performance and condition of the Ugandan banking system and assesses threats to systemic stability.

The global economy is currently exhibiting major vulnerabilities. Economic growth has virtually stalled in many advanced economies although it remains quite robust in emerging markets. In the Euro zone and many other developed economies, government and household indebtedness remains high and the health of financial institutions is fragile. Many emerging economies face challenges arising from rising inflation, rapid credit growth, exchange rate volatility and large capital inflows.

During the year to June 2011, Uganda's banking sector registered strong growth in assets and was in a financially sound condition, with a capital adequacy ratio of 17.3 percent as of June 2011, far higher than the statutory minimum of 8 percent. All commercial banks raised their minimum paid-up capital to at least Ushs.10 billion by March 2011, in line with the revisions to the statutory minimum capital requirements. Bank profitability improved with returns on both assets and equity rising. Profitability was boosted by an improvement in asset quality manifested by the fall in the ratio of non-performing loans to total loans to 1.6 percent. Nevertheless, the rapid growth in credit, especially in foreign currency loans, could generate risks to the future quality of loans.

This report outlines the steps that the Bank of Uganda is taking to improve its understanding and monitoring of the financial system. The Bank of Uganda, in collaboration with the Uganda Bureau of Statistics (UBOS), began collecting information on house prices on a quarterly basis starting in July 2011. The aim of this exercise is to construct a real estate price index which will facilitate the monitoring of trends in an asset which plays a crucial role in the financial sector and has important implications for financial stability, especially because of its use as collateral for bank loans. The Bank of Uganda is also working with commercial banks to enhance the monitoring of bank liquidity and working with other regulators to map linkages between banks and non-bank institutions.

The overall assessment of financial stability in Uganda, presented in this report, is that in the short-term at least, there are no major threats to the systemic stability. The banking sector holds substantial levels of capital, above the statutory minimum, which provide a buffer against shocks to its balance sheet. Nevertheless, the Bank of Uganda will continue to monitor potential systemic vulnerabilities closely and tackle any threats to stability which might emerge in the future.



Emmanuel Tumusiime-Mutebile
GOVERNOR

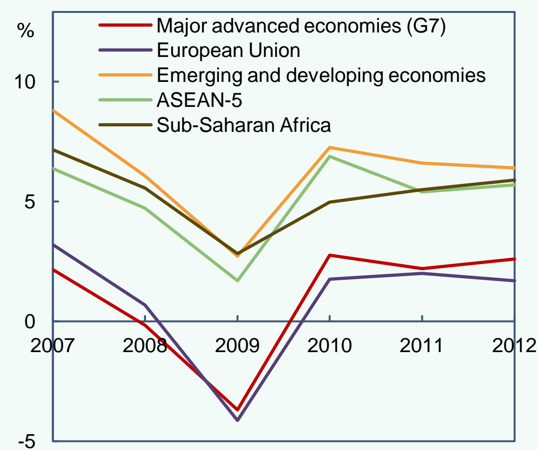
1. THE MACROECONOMIC ENVIRONMENT AND FINANCIAL MARKETS

Risks to global financial stability remain, driven by sovereign debt concerns in Europe and stalling economic growth in advanced economies. In East Africa, economic growth remains relatively robust. However, risks to regional economic stability may arise from rapid exchange rate depreciation and rising inflation.

1.1. Global economic conditions

The prospects for global financial stability remain very uncertain. This reflects unbalanced global economic performance as growth in many advanced economies has stalled while emerging and developing countries display strong growth (Chart 1). Domestic inflation has been pushed up in many emerging markets and developing countries by supply side shocks, especially commodity prices. According to the IMF World Economic Outlook Update for September 2011, global output is projected to decline from 5.1 percent in 2010 to 4 percent in 2011.

Chart 1: Annual GDP growth



Source: IMF World Economic Outlook Update, June 2011

Notes: 2012 figures are forecasts

In advanced economies, government and household indebtedness remains high, and the risks to the health of financial institutions have increased. The overall picture is one of slowing growth and declining consumer and business confidence. Volatility in global capital markets has been driven by worries about sovereign credit risk, banking sector vulnerabilities, potential contagion and the weakening prospects for economic growth. The median inflation rate in advanced economies has edged up, from 2 percent in 2010 to a projected 3.1 percent in 2011, which constrains the scope for further macroeconomic stimulus.

1.2. Emerging markets and developing countries

Growth in emerging economies has contributed to increases in commodity prices

Growth in emerging markets and developing economies is projected to decelerate in 2011 to an average of 6.4 percent from 7.3 percent in the previous year but nevertheless remains robust. Macroeconomic concerns in many of the economies in Asia and Latin America are focused largely on domestic overheating and inflation, fuelled by rapid inflows of capital, prompting policymakers to tighten monetary policies.

The growth in emerging markets has been an important driver of increases in commodity prices. Global and regional food prices (Chart 2), as measured by the Food and Agriculture Organisation's Food Price Index, increased by 39 percent in the 12 months to June 2011 and surpassed the 2008 peak.

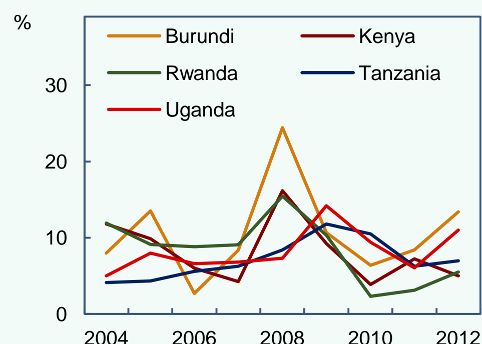
Challenges in emerging economies

In its June 2011 *Global Financial Stability Report* market update, the IMF

warned about the build-up of financial imbalances and overheating asset markets in a number of emerging economies. A key challenge to financial stability in emerging market economies (EMEs) is the increase of capital inflows due to improved investor sentiment and high interest rate differentials with developed countries. In particular, there are concerns that, fuelled by the resurgence of capital inflows, private sector credit and corporate leverage in Asia have grown too rapidly.

As was recently witnessed in Korea, episodes of high capital flows are often associated with rapid domestic credit growth and increases in asset prices to unsustainable levels. Large capital inflows also complicate macroeconomic management given their potential to generate inflationary pressure. Some countries faced with a surge in capital inflows have imposed macroprudential and capital control measures.

Chart 2: Annual Inflation for East African countries



Source: IMF, WEO Database

Notes: 2012 figures are forecasts

1.3. Developments in the East Africa region

Growth in all the five economies in the East African region was positive during 2010/2011 and higher than in the previous year (Table 1). The pickup in growth could be attributed, in part, to stronger consumer demand.

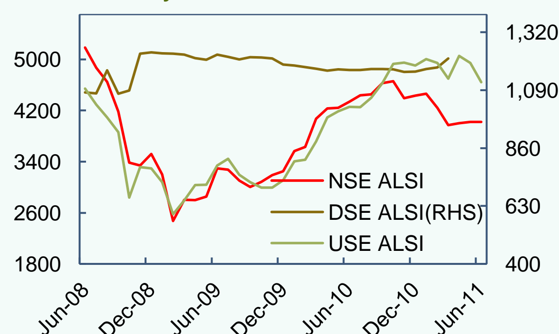
Table 1: East African countries' GDP at current prices (*US dollars, Billion*)

	2008	2009	2010	2011	2012
Burundi	1.2	1.3	1.5	1.7	1.9
Kenya	30.0	29.4	32.2	35.8	40.6
Rwanda	4.7	5.2	5.6	6.1	6.6
Tanzania	19.0	20.9	22.7	23.2	25.4
Uganda	14.4	15.8	16.0	16.4	16.6

Source: IMF, WEO Database April 2011

Note: 2012 figures are forecasts

Chart 3: Monthly East African stock indices

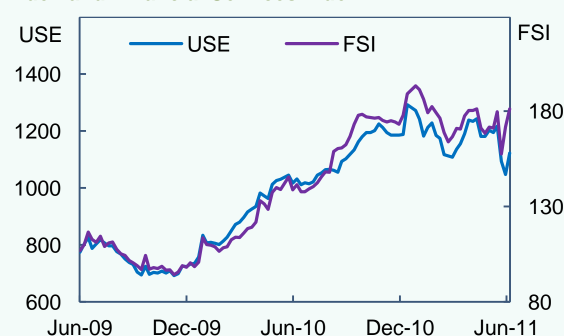


Source: Uganda Securities Exchange, Nairobi Stock Exchange and Dar-es-Salaam Stock Exchange

Equity markets

Stock market activity varied across the three regional bourses during 2010/2011. The Nairobi Stock Exchange (NSE) and the Uganda Securities Exchange (USE) All Shares Indices made significant gains during the financial year but suffered a small drop at the end of the year (Chart 3). The Dar-es-Salaam All Shares Index remained relatively stable in the same period.

Chart 4: Uganda Securities Exchange All Shares Index and Financial Services Index



Source: Bank of Uganda

The average turnover at the USE picked up, reflecting increased activity and thus liquidity of the respective stocks in the financial markets. Investors' outlook on the profitability of commercial banks listed on the USE remained optimistic, with commercial bank share prices performing relatively well, as

reflected in the composite financial services index (FSI) which outperformed the overall USE index (Chart 4).

Financial sector linkages in the region have risen

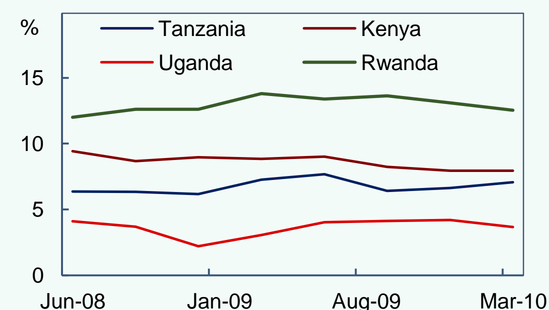
Cross-border financial sector inter-linkages within East Africa have grown in recent years. For example, four Kenyan banks and three insurance companies have opened up subsidiaries in Uganda. In addition, major international banks have subsidiaries in various East African Community (EAC) countries. The rise in cross-border financial services in East Africa is crucial for regional growth and financial system development as it spurs competition and facilitates trade and financial flows within the region. At the same time, linkages can become a powerful channel for the transmission of shocks across regional financial institutions. The potential systemic consequence of such linkages underscores the need for supervisory authorities in the region to enhance cooperation[1]. To strengthen cooperation among bank regulators in the region, the Bank of Uganda has signed memoranda of understanding with other EAC central banks which will, inter alia, enhance the sharing of information, and has undertaken joint bank inspections with its counterparts in the region.

Performance of banks in the region

Bank lending in East Africa grew strongly during 2010/2011. In Kenya, Uganda and Tanzania, banking sector gross loans and advances grew by 32.7 percent, 43.6 percent and 35.6 percent respectively. Overall, banks in East Africa were well capitalised, with the average regulatory capital to risk-weighted assets ratio at approximately 19.3 percent at end-June 2011. Banks' profitability remained largely unchanged in Kenya and Tanzania but improved in Burundi, Rwanda and Uganda. Kenya's banking sector was the most profitable with average return on equity and assets of 30.8 percent and 3.3 percent respectively in June 2011. Table 1 in the Appendix shows indicators of bank performance in the EAC region.

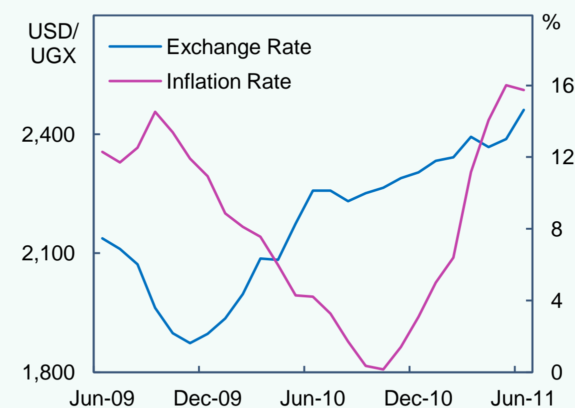
The ratio of non-performing loans (NPLs) to total gross loans was below 10 percent for all the East African countries except for Rwanda (Chart 5). The ratio of NPLs to total loans reduced markedly in Kenya, Burundi and Uganda between June 2010 and June 2011.

Chart 5: Ratio of non-performing loans to total loans for EAC countries (percent)



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

Chart 6: UGX/US dollar exchange rate and monthly headline inflation



Source: Bank of Uganda

1.4. Uganda's macrofinancial environment

Real GDP is estimated to have grown by 6.2 percent in 2010/2011, compared to 5.4 percent in the previous fiscal year. Annual headline inflation rose to

[1] The Monetary Affairs Committee (MAC) of the East African Community (EAC) requested for Technical Assistance from the IMF to enhance understanding of regional financial interlinkages and crisis preparedness in the region.

15.8 percent in June 2011 compared to 4.2 percent in June 2010, triggered by high food prices and high transport costs as a result of rising oil prices (Chart 6). The increase in inflation prompted the Bank of Uganda to tighten monetary policy, which led to a rise in interest rates. A deterioration in the balance of payments led to a depreciation of 15 percent in the shilling/dollar exchange rate between June 2010 and June 2011. The exchange rate depreciation exacerbated inflationary pressures as prices of imported commodities rose. For enterprises with a considerable amount of foreign currency debt, the depreciation may increase their loan repayment burden.

2. Key Developments in the Banking System

The Ugandan banking system has continued to perform well despite the emergence of tougher macroeconomic conditions in the first half of 2011. The sector registered significant growth and remains adequately capitalised. Asset quality continued to improve compared to the year ending June 2010. Bank profitability rose as banks reduced their operating costs. However, there are concerns about the impact on loan quality and bank liquidity, of rapid credit growth, especially lending in foreign currency.

2.1. Growth of the banking sector

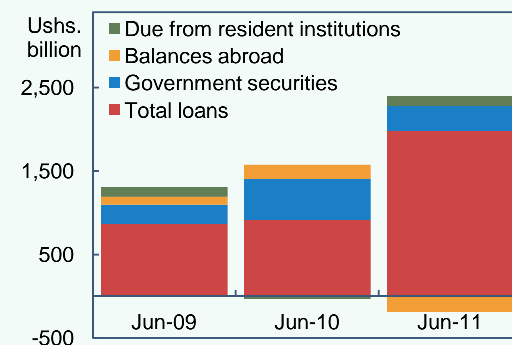
The total assets of commercial banks in Uganda grew by 23.3 percent in 2010/2011, marginally higher than 22.7 percent in the previous year. The growth of banks' assets was largely due to growth in loans which accelerated from 25.2 percent in 2009/2010 to 43.6 percent in June 2010/2011.

Table 2: Growth in banks' assets and deposits

	Jun-09	Jun-10	Jun-11
Assets			
Volumes (Ushs. trillion)	8.3	10.2	12.5
Annual growth (%)	*27.2*	*22.7*	*23.3*
Deposits			
Volumes (Ushs. trillion)	5.3	7.3	9.1
Annual growth (%)	*25.7*	*38.2*	*24.2*
Loans			
Volumes (Ushs. trillion)	3.6	4.5	6.5
Annual growth (%)	*31.2*	*25.2*	*43.6*

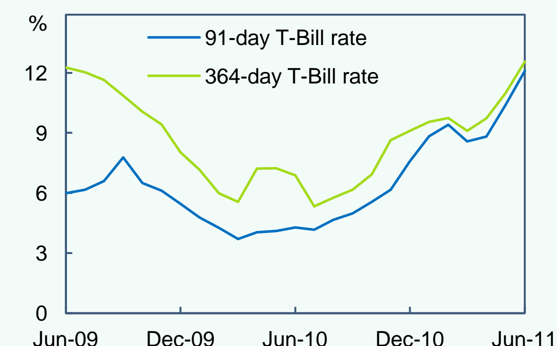
Source: Bank of Uganda

Chart 7: Annual change in volumes of banks' assets



Source: Bank of Uganda

Chart 8: Monthly interest rates on government securities

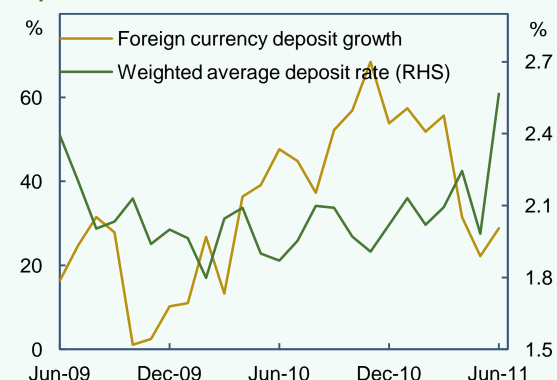


Source: Bank of Uganda

Changes in the structure of banks' assets

The year to June 2011 witnessed changes in the structure of the industry's balance sheet. Commercial banks' asset portfolios shifted to more risky assets, with risk-weighted assets as a share of total assets rising from 62 percent in June 2010 to 69 percent in June 2011. Following a period of low rates on government securities (Chart 8), banks started to move away from these assets, reducing the share of government securities in total assets from 21.6 percent to 19.9 percent. Banks also reduced their balances held with banks abroad and with the central bank during 2010/11. On the other hand, total loans as a share of total assets rose to 52.1 percent at end-June 2011, up by 7.4 percentage points from the previous year.

Chart 9: Annual growth of banks' foreign currency deposits



Source: Bank of Uganda

2.2. Funding and liquidity

While deposits remain the key source of funding, banks are turning to other sources

The year-on-year growth of deposits dropped to 24.2 percent in 2010/2011 from 39.6 percent in the previous year. Notably, the growth of foreign currency deposits slowed down to 28.8 percent in 2010/2011 compared to 48 percent in

the previous year (Chart 9). In contrast, total loans by commercial banks increased by 43.6 percent (Chart 10). The ratio of total loans to total deposits increased from 61.8 percent to 71.5 percent in June 2011, while the ratio of foreign currency loans to foreign currency deposits rose from 52.1 percent to 68.6 percent, an indicator of increased financial intermediation.

With deposit growth slowing, banks looked to other sources of funding to supplement deposits and fund asset growth. For instance, borrowings from the domestic interbank market rose during the year. The total volume traded during 2010/2011 almost doubled to Ushs.11.6 trillion, up from Ushs.6.2 trillion in 2009/2010 (Chart 11). The 7-day weighted average interbank rate rose from 2.7 percent in June 2010 to 11.1 percent in June 2011 (Chart 12). Rising interest rates were accompanied by growth in monthly average volumes traded, which went from Ushs.519.4 billion in 2009/2010 to Ushs.969.6 billion in 2010/2011.

In an attempt to access additional funding sources, commercial banks used swaps with offshore institutions to access funding in shillings using their foreign currency assets held abroad in Nostro accounts. As at end-June 2011, banks' net payable outstanding swaps were Ushs.115.4 billion (Chart 13). Reflecting this trend, balances held with non-resident institutions reduced by Ushs.189.1 billion to Ushs.987.8 billion in 2010/2011. The implications of these developments are explored further in Section 3 of this report.

Trends of other indicators of liquidity

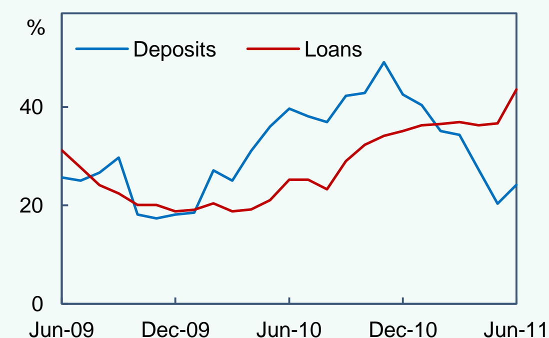
On the whole, the period to June 2011 witnessed a slowdown in growth of liquid assets; the growth of liquid assets in 2010/2011 was 6.3 percent, down from 38 percent in the previous year. Similarly, key indicators of banks' liquidity declined between June 2010 and June 2011 (Table 3). The ratio of liquid assets to total deposits fell from 41.6 percent to 35.6 percent and the share of liquid assets to total assets fell from 30.1 percent to 25.9 percent. Nevertheless, all commercial banks met the regulatory liquidity requirements during the year.

Table 3: Banks' key indicators of liquidity (*percentage ratios*)

	Jun-09	Jun-10	Jun-11
Total loans to total deposits	68.9	61.8	71.5
Total loans to demand deposits	122.9	111.8	133.7
Liquid assets to total deposits	42.2	41.6	35.6
Liquid assets to total assets	27.1	30.1	25.9
Foreign currency loans to foreign currency deposits	57.3	52.1	68.6

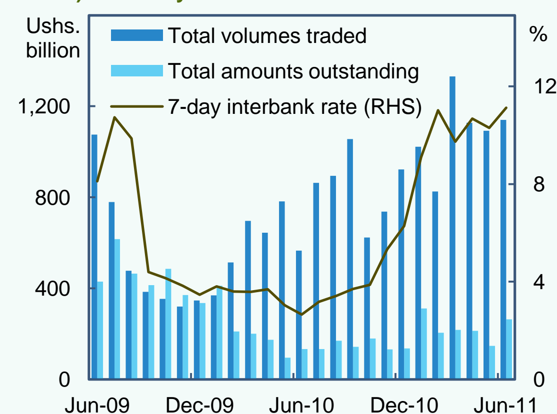
Source: Bank of Uganda

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



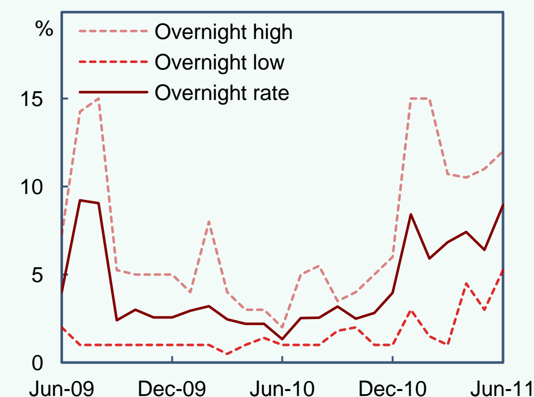
Source: Bank of Uganda

Chart 11: Monthly interbank market activity (Shs billion) and 7 day interbank rate



Source: Bank of Uganda

Chart 12: Monthly weighted average overnight interbank rates (percent)



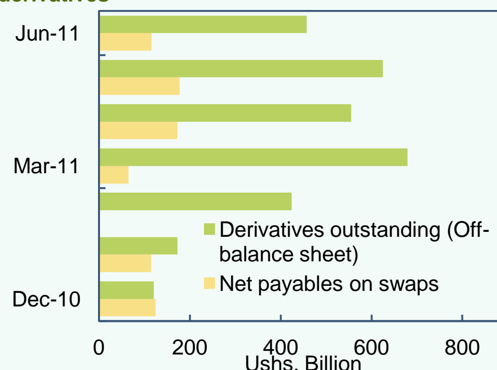
Source: Bank of Uganda

The rapid rise in credit during the year has the potential to further increase liquidity pressures on banks, since it is largely funded by short-term deposits. At end-June 2011, the share of total loans to demand deposits alone was 133.7 percent, up by 21.9 percentage points from the previous year. Banks in Uganda also remain exposed to sudden withdrawals by large depositors who may switch their investment strategies.

2.3. Performance of credit

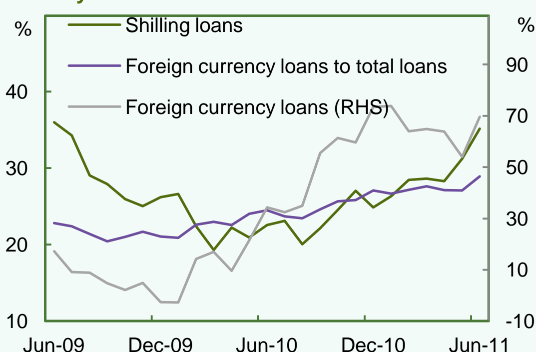
Credit to all sectors of the economy increased sharply in 2010/2011. Total loans rose by Ushs.1,977 billion to reach Ushs.6,516 billion during the year to June 2011, far higher than the increase of Ushs.914 billion in the previous year. A significant feature of this loan growth was the accelerated increase in foreign currency loans, reflecting a trend that started last year. Banks' exposure to foreign currency denominated loans rose by Ushs.772.7 billion in the period to June 2011, an annual growth rate of 69.6 percent (Chart 14). Consequently, the share of foreign currency loans in total loans went up from 24.5 percent to 28.9 percent.

Chart 13: Monthly outstanding amounts on derivatives



Source: Bank of Uganda

Chart 14: Annual growth rate of local and foreign currency loans



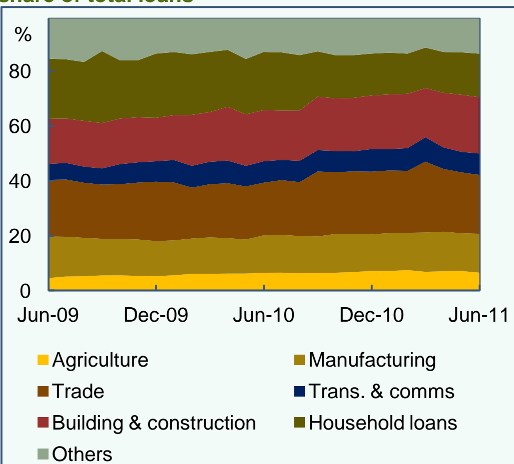
Source: Bank of Uganda

Sectoral distribution of loans

Loans to businesses grew by 53.3 percent between June 2010 and June 2011, compared to 18.9 percent in the previous fiscal year. Banks' exposure to large borrowers rose from 35.4 percent of total gross loans as at end-June 2010 to 41.7 percent as at end-June 2011, which increases concentration risk. Relative to total capital, large loan exposures grew from 112.8 percent to 156.2 percent during the same period.

Banks extended credit mostly to the trade and commerce sector and building, construction and real estate sector, and in turn, these sectors' share of banks' total lending rose to 21.5 percent and 20.5 percent respectively (Chart 15). Loans to the building, construction and real estate sector increased strongly by 58.1 percent in 2010/2011 compared to 41 percent in the previous year to June 2010 (Chart 16). Within this sector, most of the growth in loans was to property developers and estate agents whose credit rose by 65.9 percent. Loans to households grew by 7.3 percent, much lower than the growth rate of 21.1 percent in the previous year.

Chart 15: Sectoral distribution of loans, percentage share of total loans



Source: Bank of Uganda

Non-performing loans and provisioning

Banks' asset quality improved. The level of non-performing loans (NPLs) in the banking sector reduced by 30.5 percent between June 2010 and June 2011, resulting in the NPL ratio (*calculated as the ratio of NPLs to total gross loans*) dropping to 1.6 percent in June 2011 from 3.3 percent in June 2010 (see Table 4). All sectors, except households, registered a fall in their levels of NPLs over

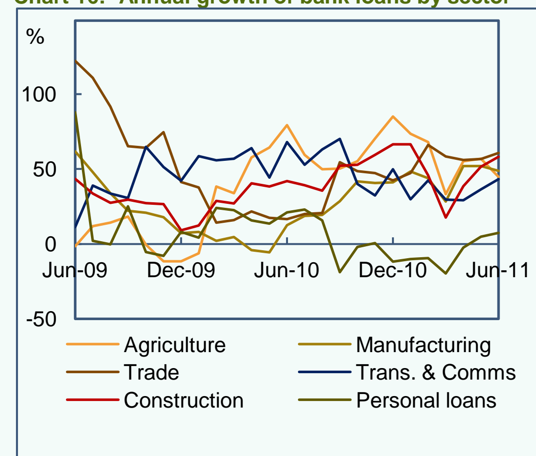
the year to June 2011. In particular, the agriculture sector's NPL ratio showed marked improvement dropping from 9.2 percent in June 2010 to 1.7 percent in June 2011, while that of the building and construction sector fell to 1.3 percent in June 2011 from 2.2 percent in June 2010 (Chart 17). The NPL ratio of the household and personal loans sector increased slightly from 1.4 percent to 1.5 percent between June 2010 and June 2011.

Table 4: Ratio of banks' NPLs total loans by sector (*percent*)

	Jun-09	Jun-10	Jun-11
Agriculture	19.0	9.2	1.7
Manufacturing	1.0	2.5	0.2
Trade	5.7	4.1	1.1
Transport & communication	1.9	2.0	0.7
Building & construction	5.7	2.2	1.3
Personal loans	-	1.4	1.5
Other activities	1.7	5.5	4.9
Overall ratio of NPLs to total loans	**4.0**	**3.4**	**1.6**

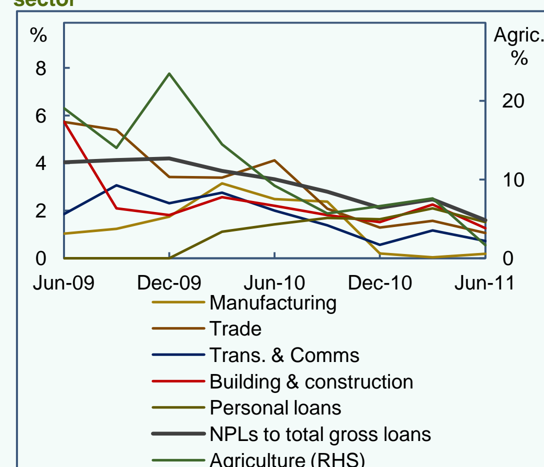
Source: Bank of Uganda

Chart 16: Annual growth of bank loans by sector



Source: Bank of Uganda

Chart 17: Quarterly changes in the NPL ratio by sector



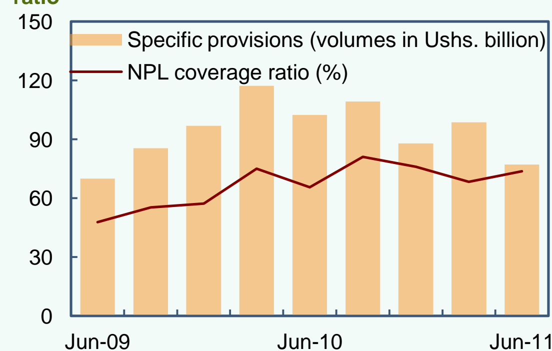
Source: Bank of Uganda

As a consequence of the overall improvement in loan quality, banks were able to reduce their loan-loss reserves by Ushs.24.7 billion to Ushs.77.2 billion in the year to June 2011. The NPL coverage ratio (*calculated as the ratio of loan loss reserves to total NPLs*) rose from 65.5 percent to 73.8 percent (Chart 18). As we indicated in the previous *Report*, although higher provisioning expenses reduce banks' profits, it reflects a prudent approach to credit risk management.

2.4. Drivers of banks' profitability

The profitability of the banking sector improved. Net income-after-tax rose by 15 percent to Ushs.354.7 billion during 2010/2011. Bank's average return on assets (ROA) went up by 0.8 percentage points to 3.1 percent while average return on equity (ROE) increased by 6.3 percent to 22.4 percent in 2010/2011. The net interest margin rose slightly to 10.5 percent during the fiscal year (Table 5).

Chart 18: Banks' provisions and NPL coverage ratio



Source: Bank of Uganda

In the year to June 2011, banks' operating costs increased by 11.8 percent to Ushs.828.1 billion. Banks' earnings, however, increased at a faster rate, resulting in the industry-wide cost-to-income ratio falling from 79.2 percent to 71.2 percent. Banks seem to have stabilised their operating costs which were rising last year. The recently licensed banks[2] also reduced the scale of their losses, mainly by expanding their balance sheets as all their major indicators of profitability improved with net loss-after-tax reducing to Ushs.27.5 billion in the

[2] Newly established banks are those banks that were licensed by the central bank after the moratorium on the entrance of new banking institutions into Uganda's market was lifted in 2006.

year to June 2011.

Table 5: Indicators of banks' profitability (*year-to-date*)

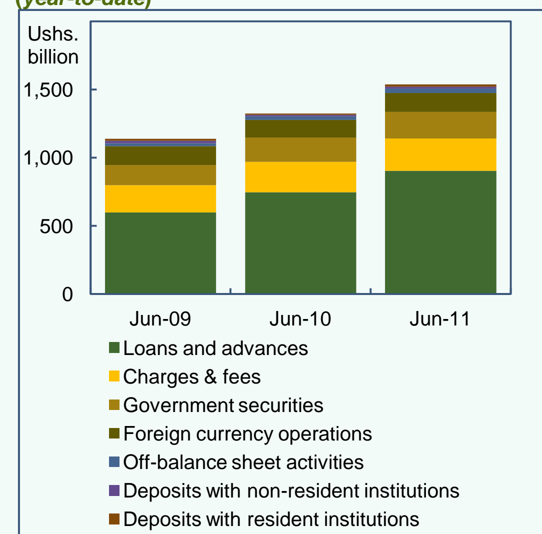
	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11
Industry					
Net profit-after-tax (Ushs. billion)	224.0	232.6	265.2	308.2	354.7
Net interest margin (%)	9.9	10.0	10.0	10.1	10.5
ROA (%)	2.3	2.4	2.7	2.9	3.1
ROE (%)	16.1	16.2	18.0	19.6	22.4
Cost to income (%)	79.2	78.7	75.7	73.5	71.2
New banks					
Net profit-after-tax (Ushs. billion)	-78.8	-73.4	-59.5	-41.6	-27.5
Net interest margin (%)	20.4	16.2	14.4	13.3	13.7
ROA (%)	-16.8	-13.9	-10.3	-6.0	-3.7
ROE (%)	-69.4	-68.4	-65.8	-34.2	-21.0
Cost to income (%)	-222.1	-201.8	-169.2	-143.1	-124.4

Source: Bank of Uganda

Earnings were largely driven by interest from lending

The main driver of banks' earnings was lending activities. The share of interest income on loans and advances to total income grew from 53.3 percent to 55 percent between June 2010 and June 2011 (Chart 19). Income from charges, fees and commissions on loans and deposits also contributed significantly to bank earnings with a share of 19.3 percent, and grew by 37.3 percent. Earnings on government securities fell from 12.8 percent to 11.9 percent of total earnings, reflecting the decline in interest rates on government securities. Income from foreign currency operations rose by 8.1 percent, compared to a decline of 7.4 percent between June 2009 and June 2010.

Chart 19: Breakdown of banks' financial income (*year-to-date*)



Source: Bank of Uganda

2.5. Capital adequacy

Banks remain well capitalised

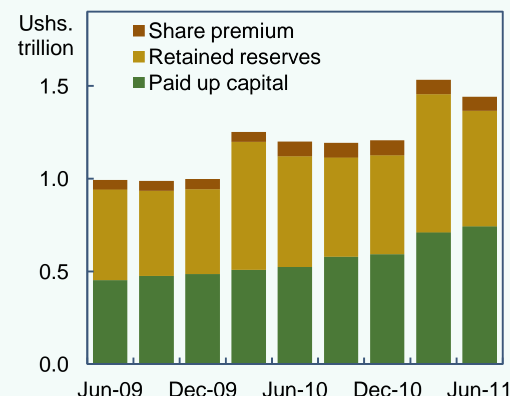
The banking industry's tier 1 capital adequacy ratio was 17.3 percent at end-June 2011, more than double the regulatory minimum of 8 percent. This ratio was lower than 19.3 percent recorded for June 2010. The drop in the ratio is attributable to the strong growth in risk-weighted assets during the year to 2011. In the year to June 2011, the share of risk-weighted assets to total assets rose from 62 percent to 69.1 percent, because of the rapid growth of loans discussed above. All commercial banks met the minimum capital adequacy requirement.

Bank leverage remained unchanged

Another indicator of capital adequacy, the leverage ratio (*regulatory tier 1*

capital to total assets) remained steady at 11.9 percent while the ratio of total capital to total assets stayed at approximately 14 percent (Table 6). These two indicators show the amount of capital banks hold to cushion against possible risks in relation to their overall balance sheet position, and not risk-weighted assets only. Although the leverage ratio for Uganda's banking system is significantly higher than the minimum 3 percent recommended by the Basle Committee on Banking Supervision (BCBS), it is prudent for these banks to hold higher capital buffers given that they operate in a riskier environment when compared to banks in advanced economies.

Chart 20: Composition of banks' total capital



Source: Bank of Uganda

Table 6: Indicators of banks' capital adequacy (*percentage ratios*)

	Jun-09	Jun-10	Jun-11
Tier 1 capital adequacy ratio	19.3	19.2	17.3
Leverage ratio	12.4	11.9	11.9
Total capital to total assets	15.0	14.0	13.9

Source: Bank of Uganda

The Bank of Uganda introduced higher minimum capital requirements in 2011. Minimum paid-up capital was raised from Ushs.4 billion to Ushs.25 billion. All banks currently in operation were required to hold at least Ushs.10 billion by March 2011 and Ushs.25 billion by March 2013. Newly licensed banks will have to begin their operations with Ushs.25 billion. All of the existing banks were able to comply with the interim capital requirement of Ushs.10 billion by March 2011. To enable compliance, banks raised more capital. Between December 2010 and March 2011, banks' paid-up capital went up by Ushs.117.4 billion to Ushs.1.7 trillion. The rise in capital will enhance the soundness of the banking system and improve the capacity of banks to absorb losses and remain resilient to shocks.

2.6. Sensitivity to market risk

Banks' exposure to movements in foreign exchange rates remained low during the year to June 2011. The industry-wide ratio of foreign currency exposure to core capital narrowed from -3.5 percent to -0.9 percent during the year. Commercial banks also maintained a fairly steady ratio of foreign currency assets to liabilities recorded at 100.1 percent at June 2011, implying virtually zero risk of currency mismatches.

Interest rate risk is also low because most lending rates which banks charge customers are variable and banks have been able to react to recent macroeconomic developments by raising lending rates. Nevertheless, credit risk on foreign currency loans may increase because of exchange rate depreciation and rising interest rates.

Table 7: Indicators of banks' foreign currency exposure (*percentage ratios*)

	Jun-09	Jun-10	Jun-11
Foreign currency exposure to regulatory tier 1 capital	-2.9	-3.5	-0.9
Foreign currency loans to foreign currency deposits	57.3	52.1	68.6
Foreign currency assets to foreign currency liabilities	109.8	98.4	100.1
Foreign currency assets to total assets	24.9	25.3	26.6
Foreign currency loans to total loans	22.8	24.5	28.9
Foreign currency deposits to total deposits	27.4	29.0	30.1

Source: Bank of Uganda

3. THE OUTLOOK FOR FINANCIAL STABILITY

The outlook for Uganda's financial stability is shaped by two factors: the risks faced by the banking system and, the system's resilience in the face of those risks. The banking system has remained relatively stable and resilient, underpinned by strong capitalisation. Although there appear to be no major threats to systemic stability in the short-term, risks, particularly to credit and liquidity, could emerge. This section presents a summary of the risks to the banking system and the outlook for financial stability.

3.1. Summary of risks facing the banking system

a) Credit Risk

Exposure to large borrowers

A key feature of the growth in loans to enterprises during the year to June 2011 was the increase in banks' exposure to large borrowers, most of whom access credit from multiple banks. Stress tests conducted by Bank of Uganda for commercial banks at end-June 2011 revealed that the risk from these exposures has increased. If each banks' single largest borrower were to default, with a loan loss of 100 percent, 11 banks would become under-capitalised with an aggregate capital shortfall of Ushs.75.3 billion. If the three largest borrowers of each bank were to default with 100 percent loan loss, 18 banks would be under-capitalised with an aggregate capital shortfall of Ushs.482.1 billion. The stress test results suggest that while the quality of loans to businesses is currently satisfactory, the banking sector is faced with imminent concentration risk from large borrowers.

Risks arising from exchange rate volatility and inflation

Bank lending rates have begun to rise, reflecting the monetary policy actions by Bank of Uganda to curb inflation. Higher lending rates will increase the debt service-to-income ratio (DIR) for households and enterprises and hence affect their ability to service existing debt. However, without reliable data on household income, it is still difficult to assess households' capacity to repay their loans. Enterprises which have borrowed in foreign currency will also face higher debt servicing costs because of exchange rate depreciation. Risks may also arise from the rise in loan exposure of banks to property developers and estate agents whose borrowing rose significantly between June 2010 and June 2011. Adverse economic shocks and rising construction costs may diminish property developer's profitability, while the rising cost of borrowing may affect the demand for property, thereby affecting loan repayment rates.

b) Funding and Liquidity Risk

Although there is little imminent threat to liquidity in the Ugandan banking sector, risks may increase in future because of the rise of banks' short-term wholesale funding and their exposure to large depositors.

As discussed in the last *Report*, commercial banks carry out foreign exchange swap transactions with non-resident financial institutions. The main motivation of banks for the use of swaps is to access short-term funding. In the recent past, the short-term liquidity needs of some of the systemically large commercial banks have increased and manifested in higher rates in the interbank market. These liquidity pressures could partly be a result of strong credit extension by these banks during the last 18 months, particularly in the mortgage sector, at a time when funding from deposits had slowed down. To access liquidity, banks

have increased the use of wholesale markets including the interbank market and swaps. If banks become too dependent on short-term wholesale funds, they will face liquidity risk in the event that access to funds in the wholesale market dries up. For example, banks which borrow from offshore financial institutions could face liquidity shortages if there were a sudden outflow of portfolio capital.

To mitigate these risks, banks should hold sufficient high quality liquid assets to meet all of their short-term liquidity needs. The Bank of Uganda is considering bringing forward the introduction of the liquidity coverage ratio (LCR) of Basel III, under which banks will be required to maintain a sufficient stock of high liquid assets sufficient to meet their short-term outflows of 30 days contractual maturity or less.

3.2. Looking ahead: the prospects for financial stability

In the six months to December 2010, conditions in the banking system improved as was manifested in higher asset quality and profitability. The strong economic growth translated into robust bank asset growth. Loan quality and deposit growth picked up, particularly foreign currency deposits, and this boosted profitability. These trends continued to the end of 2010.

Since the beginning of 2011, however, a number of vulnerabilities have emerged. The banking system has increased the share of credit in total assets. Funding and liquidity conditions in the banking system have become tighter. In addition, while banks continued to obtain funding from offshore counterparties through foreign exchange swaps, the uncertainties in international financial markets may reduce their availability. The financial performance of the parent banks of Uganda's foreign-owned subsidiaries, especially in developed countries, could also be affected by the poor economic performance in these countries. Risks could therefore arise by way of a slowdown in funding from offshore banks through swaps and other instruments.

Going forward, we expect that the banking system will face some challenges. Overall, economic conditions at home and abroad are developing in directions unfavourable to firms' business operations, and concerns about profitability will increase.

APPENDICES

TABLE 1: Selected quarterly financial soundness indicators for East African countries (*percentage ratios*)

		Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11
Regulatory Capital to Risk-Weighted Assets	Uganda	21.8	21.0	22.7	21.7	21.2	20.2	21.2	19.3
	Kenya	-	19.6	20.5	17.6	20.4	20.8	21.1	19.0
	Tanzania	19.3	18.0	20.2	-	-	18.9	19.2	18.2
	Rwanda	20.5	19.0	18.1	17.6	20.4	21.6	21.9	
	Burundi	18.6	19.1	18.8	18.7	18.0	19.7	21.7	20.7
NPLS to Total Gross Loans	Uganda	4.1	4.2	3.7	3.3	2.8	2.1	2.5	1.6
	Kenya	-	7.9	8.0	7.4	7.0	6.3	6.0	5.4
	Tanzania	6.4	6.6	7.1	-	-	9.3	9.6	9.1
	Rwanda	13.6	13.1	12.6	12.2	12.4	11.3	12.8	
	Burundi	13.6	13.0	12.7	12.1	10.6	10.0	8.8	7.6
Return on Assets (ROA)	Uganda	2.3	2.0	2.4	3.0	2.4	2.7	2.9	3.1
	Kenya	-	2.9	3.7	3.5	3.4	3.7	3.7	3.3
	Tanzania	3.4	3.2	2.7	-	-	2.3	3.0	3.0
	Rwanda	1.0	0.7	-0.2	1.3	1.6	1.9	2.5	
	Burundi	2.6	2.6	0.5	1.0	1.6	1.3	1.0	1.9
Return on Equity (ROE)	Uganda	15.2	12.7	14.3	16.1	16.2	18.0	19.6	22.4
	Kenya	-	24.8	32.4	31.4	28.6	30.7	29.4	30.8
	Tanzania	20.7	18.5	15.4	-	-	12.1	17.8	17.9
	Rwanda	7.1	5.0	-1.5	10.3	12.2	13.7	17.2	
	Burundi	22.6	22.8	4.7	8.4	13.3	21.8	6.7	13.2
Foreign Currency Denominated Assets to Total Assets	Uganda	22.7	23.0	26.1	25.3	24.6	24.7	25.7	26.6
	Kenya	-	8.1	9.4	10.2	9.7	10.6	10.7	12.4
	Tanzania	27.8	28.4	27.7	-	-	30.0	30.6	31.8
	Rwanda	19.5	20.0	19.5	0.1	0.1	21.1	18.5	
	Burundi	21.5	22.4	21.1	20.6	17.3	19.9	29.1	

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

TABLE 2: Commercial banks' quarterly financial soundness indicators (*percentage ratios*)

	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11
Capital Adequacy									
Regulatory capital to risk-weighted assets	21.1	21.8	20.9	22.7	21.7	21.2	20.2	21.2	19.3
Regulatory tier 1 capital to risk-weighted assets	19.3	19.4	18.7	19.9	19.2	18.8	17.5	18.9	17.3
Total capital to total assets	15.0	15.7	15.8	15.4	14.0	14.1	13.9	14.6	13.9
Asset quality									
NPLs to total gross loans	4.0	4.1	4.2	3.7	3.3	2.8	2.1	2.5	1.6
NPLs to total deposits	2.8	2.9	3.0	2.5	2.1	1.8	1.4	1.7	1.1
Sectoral distribution of loans									
Agriculture	4.5	5.48	5.16	6.06	6.5	6.4	7.1	5.9	6.5
Mining and quarrying	0.3	0.4	0.2	0.2	0.8	0.9	0.3	0.2	0.3
Manufacturing	15.2	13.32	12.8	13.3	13.6	13.3	13.4	12.4	14.1
Trade	20.6	19.74	21.6	19.4	19.2	23.7	22.8	22.4	21.5
Transport and comm..	5.8	5.87	7.4	8.1	7.8	7.8	8.2	7.7	7.8
Utilities	0.6	0.8	0.7	0.7	0.6	0.6	0.5	0.5	0.5
Building and construction	16.4	16.5	15.8	18.1	18.6	19.5	19.5	15.5	20.5
Personal loans	21.9	26.2	23.4	21.9	21.2	16.5	15.3	12.8	15.8
Others	19.6	19.18	19.6	13.2	13.2	12.9	13.8	7.8	13.8
Large exposures to total capital	88.6	81.0	94.3	123.9	112.8	116.1	124.4	129.8	156.2
Earnings & profitability[3]									
Return on assets	3.7	3.6	3.0	2.4	2.3	2.4	2.7	2.9	3.1
Return on equity	25.8	23.6	18.8	15.5	16.1	16.2	18.0	19.6	22.4
Net interest margin	10.7	11.1	10.8	10.0	9.9	10.0	10.0	10.1	10.5
Cost of deposits	3.0	3.5	3.7	3.5	3.3	3.2	2.9	2.7	2.5
Cost to income	69.5	71.3	75.4	78.9	79.2	78.7	75.7	73.5	71.2
Overhead to income	49.4	50.5	52.3	53.0	53.7	54.0	53.1	52.5	50.4
Liquidity									
Liquid assets to total deposits	42.2	43.6	44.7	45.5	41.6	40.5	39.8	40.5	35.6
Total loans to total deposits	68.9	70.4	71.7	67.8	61.8	63.8	68.0	69.1	71.5
Market Sensitivity									
Foreign currency exposure to regulatory tier 1 capital	-2.9	-0.9	-0.7	-3.0	-3.5	-11.8	-1.6	-2.1	-0.9
Foreign currency loans to foreign currency deposits	57.3	53.3	57.9	59.2	52.1	54.4	65.2	63.4	68.6
Foreign currency assets to foreign currency liabilities	109.8	108.7	107.0	101.1	98.4	96.3	98.0	98.1	100.1

Source: Bank of Uganda

[3] Earnings ratios are calculated based on year-to-date data.

TABLE 3: Commercial banks' quarterly balance sheet

	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11
ASSETS (Ushs. Billion)									
Cash & cash assets	356.9	330.4	401.5	395.1	453.3	439.5	480.0	451.6	476.7
Balances with BOU	487.9	534.0	623.6	587.6	917.1	747.7	793.1	726.5	817.6
Due from financial institutions	1280.6	1170.7	1016.6	1336.3	1414.4	1373.2	1289.0	1494.1	1338.9
Government securities	1704.5	1816.9	1832.3	2031.9	2196.2	2422.0	2526.5	2575.0	2498.2
Total gross loans & advances	3624.6	3741.7	4038.9	4260.9	4539.0	4825.0	5456.7	5834.5	6516.2
LESS: Provisions	-105.1	-121.7	-135.2	-117.3	-102.5	-109.2	-88.0	-98.7	-77.2
Net loans & advances	3519.5	3620.0	3903.6	4143.6	4436.5	4715.7	5368.8	5735.8	6439.0
Net fixed assets	446.7	448.1	472.9	334.7	342.8	375.9	401.7	397.7	400.9
Other assets	372.0	400.1	344.2	313.5	394.8	376.4	437.3	471.7	545.3
TOTAL ASSETS	**8168.1**	**8320.3**	**8594.7**	**9170.6**	**10155.1**	**10450.5**	**11296.4**	**11852.4**	**12516.5**
LIABILITIES (Ushs. Billion)									
Deposits	5242.5	5315.9	5630.5	6287.9	7344.7	7563.3	8023.5	8444.7	9118.7
Due to financial institutions	639.3	616.5	602.9	388.4	381.7	384.9	475.0	379.9	308.2
Administered funds	321.9	297.1	279.2	475.3	230.6	293.0	310.6	279.6	303.9
Other liabilities	722.3	722.3	722.3	722.3	722.3	722.3	722.3	722.3	722.3
TOTAL LIABILITIES	**6926.0**	**6995.4**	**7213.7**	**7761.6**	**8732.2**	**8972.8**	**9730.6**	**10117.8**	**10777.0**
CAPITAL (Ushs. Billion)									
Paid-up capital	452.3	475.5	485.8	508.0	523.8	578.2	591.9	709.3	743.4
Share premium	52.6	55.1	55.1	55.1	78.9	80.3	80.3	77.0	77.0
Retained reserves	488.5	458.0	456.7	689.4	596.5	535.4	534.1	746.2	621.6
Other reserves/subordinated debt	103.5	140.4	147.3	104.9	102.1	96.8	89.7	107.6	84.9
Profit – Loss (current year)	145.3	195.9	236.1	51.5	121.5	187.0	269.8	94.5	212.6
TOTAL SHAREHOLDERS' FUNDS	**1242.1**	**1324.9**	**1381.0**	**1409.0**	**1422.9**	**1477.7**	**1565.7**	**1734.6**	**1739.5**
OFF BALANCE SHEET ITEMS (Ushs. Billion)									
Letters of Credit	241.0	196.4	201.9	231.0	293.3	299.7	335.8	368.4	419.6
Guarantees & performance bonds	412.4	457.7	520.5	519.4	678.8	668.3	606.6	640.8	706.5
Unused loans/overdrafts commitment	260.9	271.0	318.1	480.7	519.8	499.5	676.7	571.0	601.5
Other off balance sheet items	149.8	172.2	147.2	-30.7	636.7	261.3	120.3	679.2	457.3
TOTAL OFF BALANCE SHEET ITEMS	**1064.2**	**1097.3**	**1187.8**	**1200.3**	**2128.5**	**1728.8**	**1739.4**	**2259.3**	**2184.9**

Source: Bank of Uganda

TABLE 4: Commercial banks' quarterly income statement, year-to-date figures

	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11
INCOME (Ushs. Billion)									
Interest income									
Advances	599.2	658.2	693.2	721.5	747.5	760.4	794.2	840.9	903.8
Government securities	149.6	156.4	166.7	174.4	179.4	183.0	183.7	185.6	194.6
Deposits abroad	18.2	15.2	12.4	10.8	11.3	10.7	10.8	11.6	12.8
Other	73.8	73.9	65.6	54.6	48.7	40.0	44.2	49.4	52.3
Charges, fees & commissions	197.9	208.3	219.0	225.7	221.7	214.9	215.5	218.9	236.5
Foreign exchange income	138.0	149.1	131.5	128.3	127.8	133.7	133.7	140.6	138.1
Other income	51.9	54.1	55.9	53.7	64.8	78.3	95.8	103.8	103.7
TOTAL INCOME	**1228.7**	**1315.2**	**1344.3**	**1369.1**	**1401.3**	**1420.9**	**1477.9**	**1550.7**	**1641.9**
EXPENSES (Ushs. Billion)									
Interest expense on deposits	139.7	160.9	188.9	200.6	210.2	205.5	199.0	199.1	205.4
Other interest expenses	67.8	74.7	64.3	64.3	64.0	56.3	57.3	64.1	69.1
Provisions for bad debts	45.2	42.5	56.3	87.0	81.7	88.0	77.9	61.6	67.6
Salaries, wages, staff costs	250.0	271.5	287.6	298.6	311.2	317.4	332.2	345.1	354.1
Premises, depreciation, transport	130.8	141.6	145.0	149.8	155.3	160.1	154.3	158.7	162.0
Other expenses	217.4	242.3	266.3	273.8	284.5	290.2	298.2	311.0	312.0
TOTAL EXPENSES	**805.7**	**891.0**	**952.0**	**987.0**	**1025.2**	**1029.6**	**1040.9**	**1078.1**	**1102.6**
ADD: Extraordinary credits/charges	0.0	0.0	0.0	-0.1	-0.4	-0.4	-0.4	0.2	0.6
Net profit before tax	377.8	381.7	335.9	294.9	294.0	303.0	358.7	411.3	472.2
LESS: Corporation tax	97.2	101.8	84.0	75.8	70.0	70.4	93.5	103.0	117.5
NET PROFIT AFTER TAX	**280.8**	**280.1**	**251.9**	**219.1**	**224.0**	**232.6**	**265.2**	**308.2**	**354.7**

Source: Bank of Uganda