Bank of Uganda

FINANCIAL STABILITY REPORT

June 2017 | Issue No. 9

© Bank of Uganda 2017

Address: 37 - 45 Kampala Road

Postal: P.O. Box 7120, Kampala

Tel: +256 414 258 441-6

Fax: +256 414 233 818

Email: **info@bou.or.ug**

Web: **www.bou.or.ug**

ISSN print: 2079-6293

ISSN web: **2079-6307**

CONTENTS

Glossary 5

A Note on Financial Stability 6

Foreword And Assessment Of Financial Stability 7

1. The Macroeconomic Environment And Financial Developments 9

1.1. Global economic conditions 9

1.2. Emerging and developing countries 9

1.3. Developments in the East Africa region 11

1.4. Uganda's macro financial environment 14

1.5. Conclusion 17

2. Key Developments In Uganda's Banking Sector 18

2.1. Growth of the banking sector 18

2.2. Capital adequacy 18

2.3. Funding and liquidity conditions 19

BOX 1: Banks' liquidity and the central bank's open market operations 22

2.4. Banks' lending activity 22

2.5. Asset quality 24

2.6. Earnings and profitability 26

BOX 2: Decomposition of profitability ratios using DuPont analysis 28

2.7. Performance of domestic systemically important banks (DSIBs) 31

2.8. Performance of other deposit-taking financial institutions 33

2.9. Conclusion 34

3. Financial Infrastructure Oversight and Other Financial Corporations 35

3.1. Performance of payments systems 35

Box 3: De-risking in the global financial system and its implications for Uganda 41

3.2. The capital markets 42

3.3. The retirement benefits sector 44

3.4. The insurance sector 45

3.5. Interconnectedness in the financial sector 46

4. The Outlook for Financial Stability 48

4.1. Summary of risks facing the banking sector 48

4.2. Stress test results for the banking sector 48

4.3. Looking ahead: prospects for financial stability 49

5. Exploring The Factors Affecting The Performance Of Bank Credit To Uganda's Real Estate Sector ...51

5.1. Introduction 51

5.2. Rationale 51

5.3. Methodology 52

5.4. Survey findings 52

6. STATISTICAL APPENDICES 61

APPENDIX 1: Selected quarterly financial soundness indicators for East African countries 61

APPENDIX 2: Commercial banks' quarterly financial soundness indicators 62

APPENDIX 3: Commercial banks' quarterly balance sheet 63

APPENDIX 4: Commercial banks' quarterly income statement, year-on-year figures 64

GLOSSARY

ALSI	All Shares Index
BCBS	Basel 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
NSFR	Net Stable Funding Ratio
RHS	Right hand side
ROA	Return on assets
ROE	Return on equity
UBOS	Uganda Bureau of Statistics
USh.	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 Financial Stability Report analyses the performance and condition of the Ugandan banking system and the Bank's assessment of potential threats to systemic stability.

Global financial stability conditions have improved since our last Report, amid broadly accommodative monetary and financial policies in advanced and emerging markets. In Uganda, real GDP growth is projected to pick up to 5.5 percent for the fiscal year 2017-18, supported by scaled-up public investment in planned infrastructural projects and a more relaxed monetary policy stance.

The Ugandan banking sector remains sound and stable with adequate capital and liquidity buffers. The industry's aggregate tier one capital adequacy ratio and the total capital adequacy ratio increased from 19.0 percent and 21.7 percent at June 2016 to 21.4 and 23.6 percent at June 2017 respectively, well above the minimum requirements. The ratio of non-performing loans to total loans (NPL ratio) decreased from 8.3 percent to 6.2 percent between June 2016 and June 2017. A major challenge faced by banks was the slow growth of loans, which rose by only 0.9 percent between June 2016 and June 2017, far lower than 3.7 percent growth recorded in the previous year. In particular, banks constricted credit to the real estate sector, reflecting the elevated risks from the slowdown in residential property prices. The Bank conducted a survey targeted at commercial banks with significant exposure to the real estate sector and borrowers within the sector, in order to appropriately determine the factors affecting the performance of credit to the sector. The results of the survey are provided in Chapter 5 of this report.

Uganda's payments infrastructure remained stable in the year to June 2017, although there were some incidences of de-risking of few banks by correspondent banks. This did not materially impact the banks involved nor affect the financial system. Details of the effects of de-risking on the financial system and BOU's actions to strengthen the legal and regulatory framework against money laundering and terrorism financing are detailed in Chapter 3.

The overall assessment of financial stability in Uganda, presented in this Report, is that there are no major threats to the systemic stability at the moment. 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

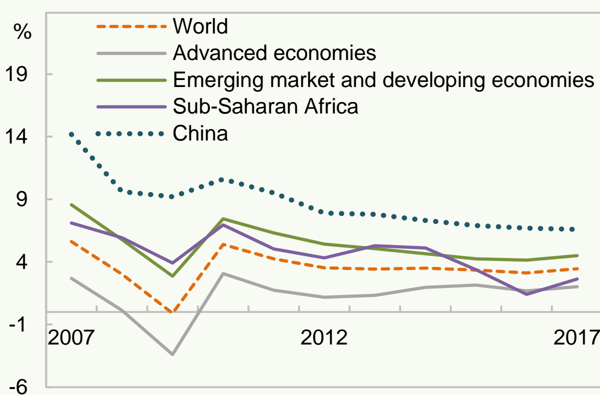
1. The Macroeconomic Environment And Financial Developments

Global financial stability has improved since our last Report, amid broadly accommodative monetary and financial conditions. However, threats to financial stability are emerging from elevated political and policy uncertainty and opening up new channels for negative spill-overs. Growth prospects in developing and emerging economies are threatened by lower commodity revenues and potential for capital outflows triggered by shifts in policies in advanced economies. Nonetheless, efforts to raise potential output and maintain financial stability are being prioritised based on country-specific conditions, including investing in infrastructure, improving revenue mobilisation, strengthening debt management and enhanced macroprudential policy framework.

1.1. Global economic conditions

Global economic activity firmed up in the year to June 2017, which improved the near term outlook for financial stability. The IMF projects global growth to increase to 3.5 percent in 2017 and 3.6 percent in 2018[1]. Indicators show that global macroeconomic risks are lower amid the global upswing in economic activity.

Chart 1: Annual GDP growth for selected economic regions (percent)



Source: IMF WEO Database April 2017

Advanced economies continue to face an environment of benign macroeconomic conditions amidst sluggish inflation, which has fuelled a marked increase in risk appetite, broadened investors search for yield, which may increase rising market volatility. This environment has also seen a rise in private sector and household indebtedness and a general increase in leverage. On a positive note, ongoing measures to strengthen the global financial system seem to be paying off in terms of strengthening capital cushions and cleaning up balance sheets of the banking system, especially in the United States (U.S.) and United Kingdom (U.K.).

1.2. Emerging and developing countries

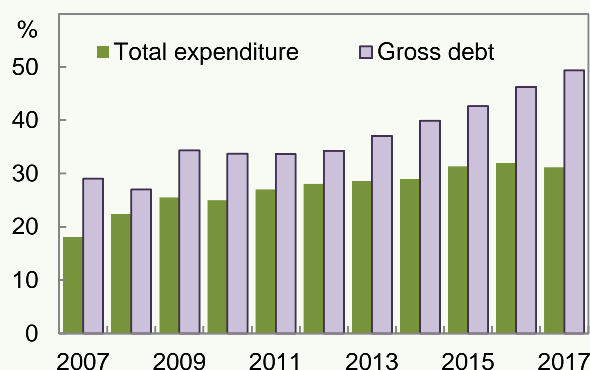
Emerging market risks also declined, underpinned by the pick-up in global activity and benign external conditions. A key stability challenge is the rebalancing of central bank and private sector portfolios, in an orderly way that will minimise unwanted turbulence in financial markets. Large scale monetary accommodation in advanced economies has underpinned a significant portion of portfolio flows to emerging market economics. The IMF estimates that Federal Reserve policy normalisation over the next two years could reduce portfolio flows by about USD35.0 billion a year. These conditions, coupled with a shift toward protectionism in advanced economies could reignite capital outflow pressures from emerging markets.

In China, concerns about the government's spending drive, combined with soaring property prices and rising debt levels, were alleviated by the strong growth in the country's economy during the first half of 2017. However, the extent to which the growth

[1] IMF World Economic Outlook April 2017

recovery was fuelled by further large increases in debt and the consequences are yet to fully emerge. Hence, the speed of China's policy actions to curb excessive credit growth could have a potential effect on the forecast growth, and spill-overs to other countries through trade, commodity price and confidence channels.

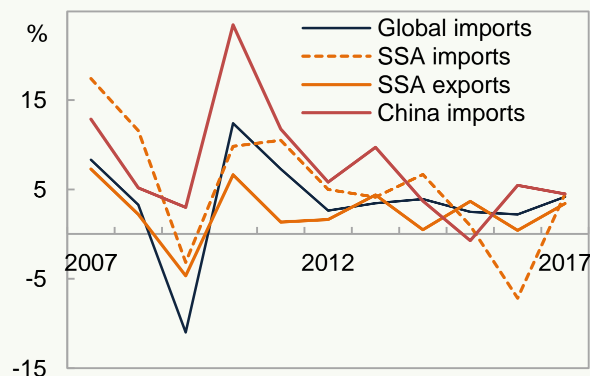
Chart 2: Annual general government expenditure and debt for China (percent)



Source: IMF WEO Database April 2017

Several emerging markets also continue to face challenges adjusting to the external shocks that have arisen in recent years, such as the decline in their terms of trade, oil production cuts, lower commodity prices, as well as country-specific factors.

Chart 3: Annual changes in global and SSA trade volumes of goods and services (percent)

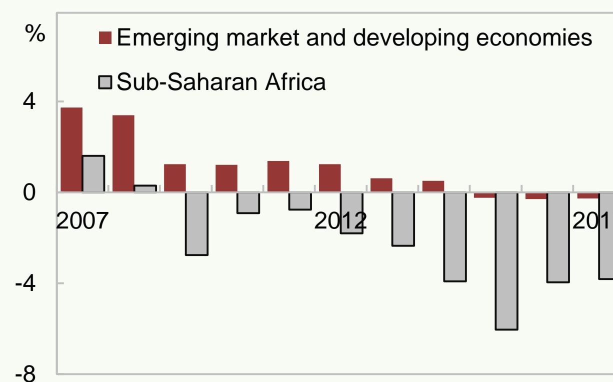


Source: IMF WEO Database April 2017

Sub-Saharan Africa

Africa's economic growth started to recover in 2017 while oil-exporting countries saw the largest shock to their economies. The majority of non-commodity exporting African countries maintained positive growth, and commodity importers benefited from a lower oil import bill. The outlook for the Sub-Saharan Africa (SSA) region shows that growth is projected to rise to 2.6 percent in 2017 and 3.5 percent in 2018 supported by infrastructure investment, increased diversification and exports and improved business environment. However, still-large structural economic imbalances have continued to weigh down on the forecast for continued growth, including adverse weather conditions which impacted on agriculture production in some regions and raised inflation pressures.

Chart 4: Current account balance as a percentage of GDP (percent)



Source: IMF WEO Database April 2017

Also, economic changes in China and the United States will have varying effects on Africa's trade. The challenge is that external financing requirements are increasing exactly at the same time as financial conditions are tightening. The United States' is set to raise interest rates, which not only increases refinancing costs and the cost of new borrowing, but also dampens the search for yield and reduces the appetite for risk that had pushed investors to venture in frontier markets, including in Africa.

1.3. Developments in the East Africa region

Growth in all the five economies in the East African Community (EAC) region was positive in 2017 as indicated in Table 1.

In Kenya, Uganda's main export market, investments in infrastructure and a high household consumption rate drove growth amid a decline in tourism due to security concerns. In Rwanda, agriculture and services were key growth sectors, although low commodity prices, especially for coffee and tea, and poor infrastructure impeded growth. In Tanzania, a robust domestic demand for the growing services and manufacturing sectors were the main drivers of the economy[2]. The Economic Commission for Africa forecasts that the region's growth will increase to 6.0 percent in 2017 and 6.3 percent in 2018, backed by robust performance in Kenya, Rwanda and Tanzania.

Table 1: East African countries' GDP growth rates (percent)

	2014	2015	2016	2017
Burundi	4.5	-4.0	-1.0	0.0
Kenya	5.3	5.6	6.0	5.2
Rwanda	7.6	8.9	5.9	6.1
Tanzania	7.0	7.0	6.6	6.8
Uganda	5.2	5.0	4.7	5.0

Source: IMF WEO Database April 2017

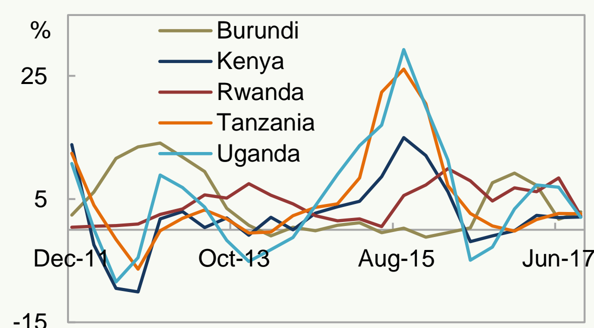
Table 2: Annual inflation for East African countries (percent)

	Jun-16	Sep-17	Dec-17	Mar-17	Jun-17
Burundi	3.9	7.0	9.6	21.1	15.1
Kenya	5.8	6.3	6.3	11.7	9.2
Rwanda	4.2	4.8	5.3	5.4	4.8
Tanzania	5.5	4.5	5.0	6.4	5.4
Uganda	5.9	4.3	5.7	6.4	6.4

Source: EAC Member States

The region's currencies experienced a gradual depreciation against the U.S. dollar during the financial year 2016-2017, although they stabilised toward the end of the second quarter of 2017. Inflation in the region peaked at an average of 10.2 percent in March 2017 from 5.1 percent in June 2016, mostly due to prolonged drought and falling currencies. Going forward, inflation is expected remain low and stable over the medium term.

Chart 5: Annual changes in EAC regional currencies against USD (percent)



Source: EAC Member States

All countries in the region experienced widening fiscal deficits which was mostly driven by large scale infrastructure investments. Furthermore, these economies continue to face serious threats ranging from political uncertainty[3] and weakening trade relations to worries over a slump in foreign direct investment and cuts in development aid.

[2] "Urbanisation and Industrialisation for Africa's Transformation", Economic Report on Africa 2017 by the United Nations Economic Commission for Africa

[3] Presidential elections in Kenya and Rwanda in August 2017 are expected to dampen business sentiment in the entire region.

Table 3: General gross government debt for East African countries (percentage of GDP)

	2014	2015	2016	2017
Burundi	35.7	46.0	47.2	57.1
Kenya	48.6	52.4	54.4	54.7
Rwanda	29.1	33.4	37.6	41.4
Tanzania	33.8	36.9	39.0	40.3
Uganda	30.1	33.2	36.9	40.1

Source: IMF WEO Database April 2017

Financial performance of banks in the region

Private sector lending by banks in the EAC region slowed down in the year to June 2017, with Burundi witnessing a contraction of 4.2 percent, for the period under review. The slowdown in credit growth partly reflected banks' aversion to risk amidst a decline in loan quality and a challenging economic environment in the region. Data on asset quality in the region revealed that credit risk rose between June 2016 and March 2017 as all countries experienced a gradual increase in NPL ratios during this period. Tanzania's banking sector registered the largest increase in their aggregate NPL ratio, 1.9 percentage points to reach 10.9 percent in June 2017. Burundi maintained the highest NPL ratio in the region with 11.5 percent as at the end of June 2017.

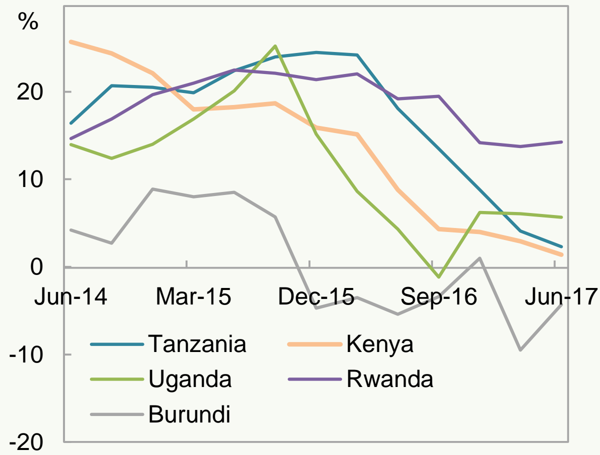
The slowdown in credit growth in the region occurred despite falling interest rates, with the exception of Tanzania. The most notable change in lending rates occurred in Kenya following the regulation on interest rate caps which was passed by the Parliament of Kenya in September 2016[4].

Between August 2016 and June 2017, the average lending rate in Kenya dropped from 17.7 percent to 13.7 percent, during which period annual private sector credit growth declined by 2.9 percentage points to reach 1.5 percent. In the short- to medium-term, the impact of the caps is likely to be two-fold: a contraction in the supply of credit to the private sector as banks tighten lending standards to guard against credit risk; and a fall in banks' earnings because of the narrowing interest margins. Nevertheless, the full impact of the law is yet to be determined.

While the drop in interest rates was not as drastic in the other East African countries, the narrowing interest margins, coupled with slow credit growth, had an overall negative impact on banks' profitability in the region. On average, regional bank profitability as measured by banks' return on assets decreased from 2.8 percent in the year to June 2016 to 2.3 percent in the year to June 2017.

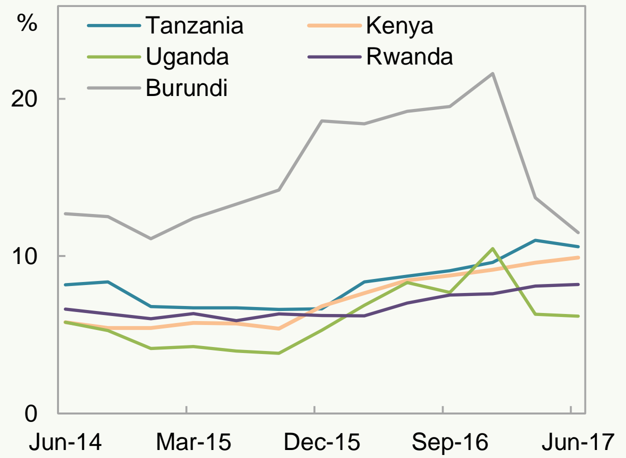
[4] Commercial banks in Kenya are required to extend loans at rates that are four percentage points above the policy rate, and offer deposit rates at 70 per cent of the policy rate.

Chart 6: Annual growth of credit extended to the private sector by banks in the EAC region (percent)



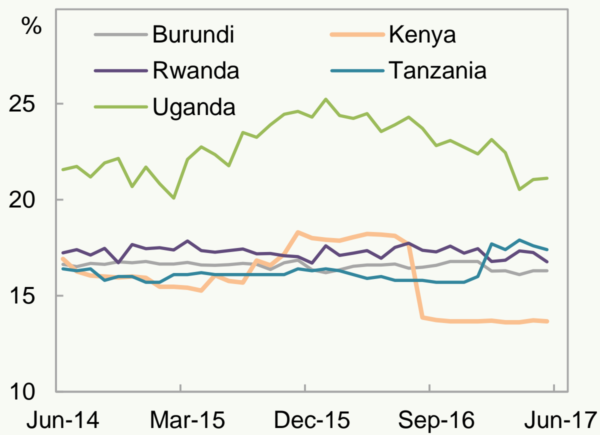
Source: EAC Central Banks

Chart 7: Quarterly ratio of non-performing loans to total loans for banks in the EAC region (percent)



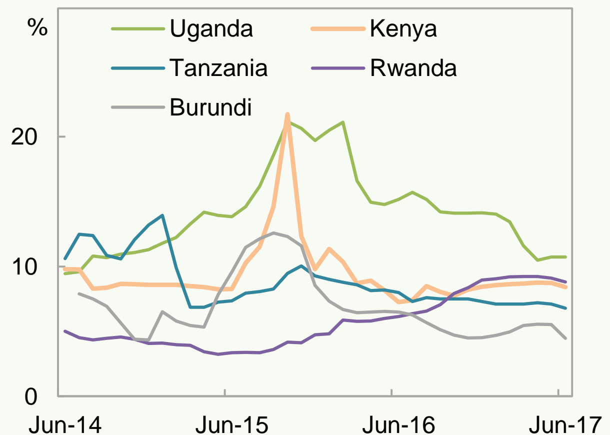
Source: EAC Central Banks

Chart 8: Weighted average lending rates for banks in the EAC region (percent)



Source: EAC Central Banks

Chart 9: Yields on 91-day Treasury bills for EAC member states (percent)

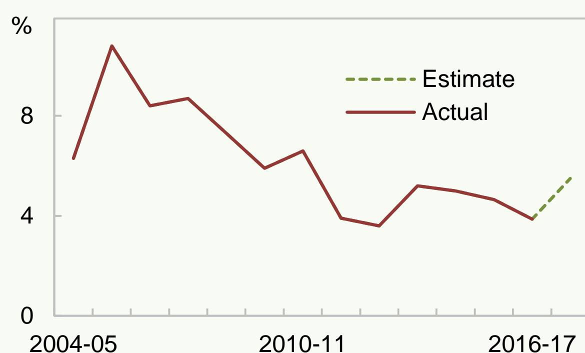


Source: EAC Central Banks

1.4. Uganda's macro financial environment

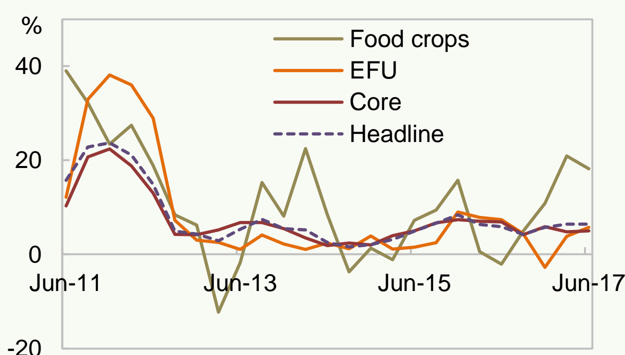
The Ugandan economy grew by 4.0 percent in the year to June 2017, 0.8 percentage points lower than that achieved in the financial year of 2015-2016. The economy was mainly affected by global economic imbalances, the impact of adverse weather conditions on crop production, and geo-political events in key trading partner countries. However, real GDP growth is projected to pick up to 5.5 percent for the fiscal year 2017-18, supported by scaled-up public investment in planned infrastructural projects, and a more relaxed monetary policy stance.

Chart 10: Annual real GDP growth (percent)



Source: Bank of Uganda

Chart 11: Domestic annual inflation (percent)

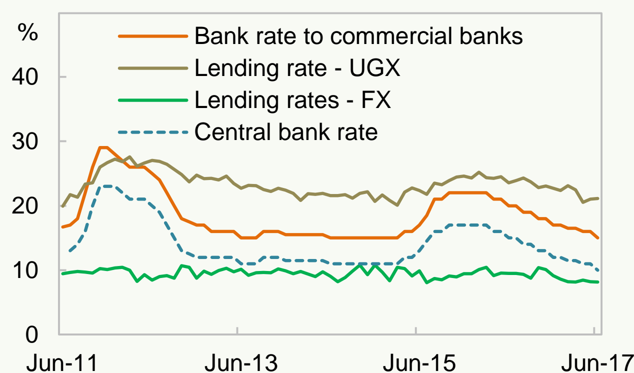


Source: Bank of Uganda

Inflation and interest rates

Poor crop production had a marked impact on food price inflation across the East African region. In Uganda, inflationary pressures in the second quarter of 2017 could almost entirely be attributed to high food prices, with non-food price inflation remaining subdued. As food inflation rose to 18.1 percent in the year to June 2017, headline inflation reached 6.4 percent in the same period, compared to 5.9 percent in June 2016. In order to stimulate economic activity, the Bank of Uganda relaxed its monetary policy stance by consistently reducing the central bank rate in the year to June 2017, from 15.0 percent to 10.0 percent. In the short- to medium-term, inflation is expected to remain stable, although any changes will depend mostly on food and other commodity prices, as well as the developments in the foreign exchange market.

Chart 12: Monthly interest rates (percent)



Source: Bank of Uganda

Credit conditions

Growth in private sector credit improved in the year to June 2017, though only slightly compared to the previous year, from 4.3 percent to 5.7 percent. As a share of GDP, private sector credit remained largely below its long-term trend during the period under review. As at the end of June 2017, the credit-to-GDP ratio was 0.6 percentage points below its long-term trend (Chart 13). Furthermore, considering that 20.5 percent of bank lending is to the real estate and construction sector (details in Chapter 2), the reduction in property prices observed during the year is likely to exacerbate levels of credit risk in the economy. In particular, the Residential Property Price Index (RPPI) rose by 6.0 percent between June 2016

and June 2017, compared to 8.0 percent in the previous year. Hence, further defaults resulting in more foreclosures may flood the market with repossessed properties which may drive prices down even more.

Chart 13: Trends in private sector credit (percent)

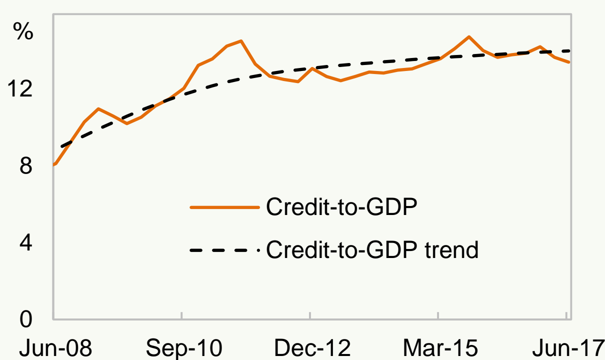
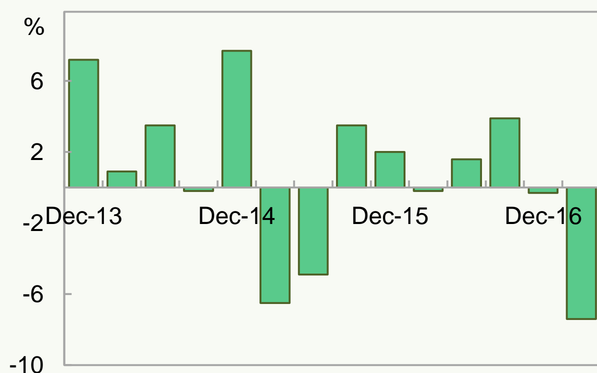


Chart 14: Quarterly changes in the Residential Property Price Index (RRPI) (percent)

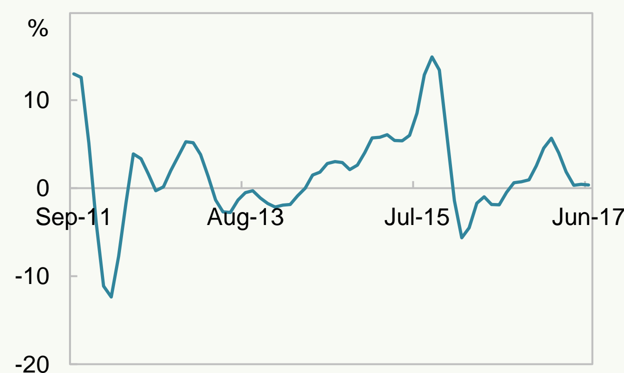


The external sector

The external vulnerabilities presented by subdued global growth and declining commodity prices affected exchange rate stability, which in turn translated into price inflation. The average exchange rate experienced sharp depreciation towards the end of 2016 and into the first quarter of 2017, peaking at a rate of 6.4 percent in the quarter ending December 2016 (Chart 15).

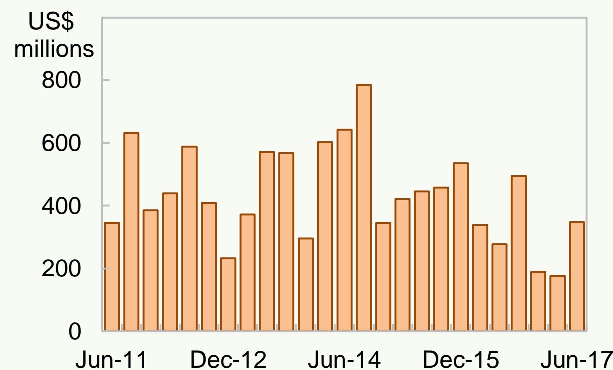
The pass-through from the exchange rate depreciation to imported prices, together with high food prices, led to rising domestic inflation. The impact of these events on the Uganda's current account was a gradual decline in the deficit during the year to June 2017, as the country spent less on imports, possibly due to dampened domestic demand (Chart 16). However, by the end of June 2017, the current account deficit stood at USD347.1 million, signalling potential recovery in import activity amid reduced exchange rate volatility.

Chart 15: Quarterly changes in average exchange rate for the Ugandan shilling against the US dollar (percent)



Source: Bank of Uganda

Chart 16: Quarterly current account deficit (US$, millions)



Source: Bank of Uganda

Fiscal performance

In the year to June 2017, the stock of government debt increased by 16.7 percent from USh.29.0 trillion to USh.33.8 trillion, although this was lower than the change of 20.0 percent between June 2015 and June 2016. On the other hand, the fiscal deficit reduced by 9.5 percent as growth in government revenue exceeded that in expenditure. However, the share of

government debt to GDP increased from 34.9 percent to 39.2 percent due to government borrowing exceeding economic growth during this period. Meanwhile, the ratio of external debt to GDP rose from 21.7 percent to 23.9 percent between June 2016 and June 2017. While the rising external financing needs make Uganda vulnerable to market volatility, Bank of Uganda has sufficient foreign reserve holdings to absorb external shocks. As at the end of June 2017, Uganda's foreign exchange reserves stood at USD3.4 billion, equivalent to 5.3 months' worth of import cover.

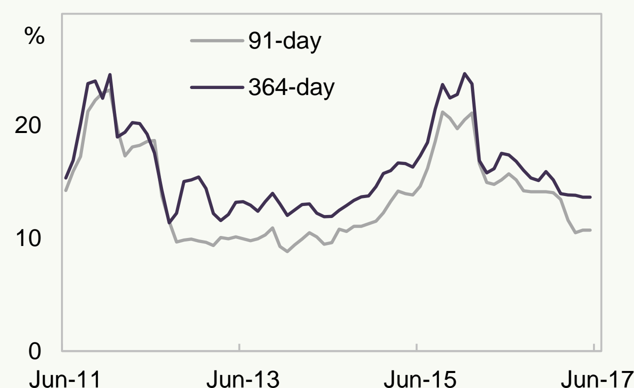
Chart 17: Domestic and external government debt as a share of GDP (percent)

Source: Bank of Uganda

Domestic financial institutions continued to be the largest lenders to the government, accounting for 83.1 percent of holdings in treasury securities (Chart 19). The level of government borrowing from the domestic market increased by 3.8 percent between June 2016 and June 2017, although this was lower than the change of 16.5 percent in the financial year 2015/16. Furthermore, of the total domestic debt, 44.2 percent is due to mature within 12 months, which is above the recommended benchmark of 40.0 percent.

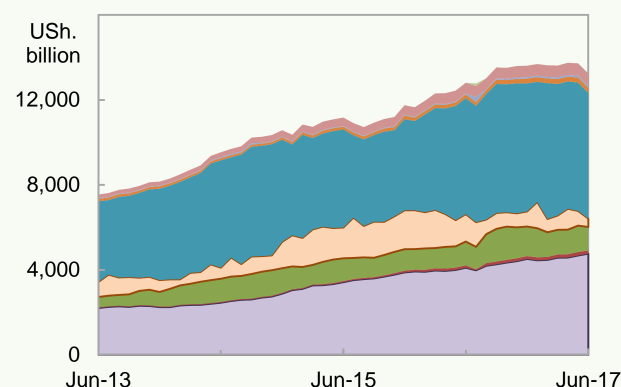
Chart 18 shows a gradual decline in yields on government securities in the year to June 2017, likely driven by banking institutions' preference for low-risk securities over credit extension. During this period, the rate of return on both 91-day and one-year treasury bills reduced by approximately 4.0 percentage points.

Chart 18: Monthly yields on government securities (percent)



Source: Bank of Uganda

Chart 19: Breakdown of holdings of treasury securities by investor (USh. billion)



Source: Bank of Uganda

The Government of Uganda has committed to scaling down new domestic borrowing over the medium term

in order to support the private sector. They will also be taking steps to lengthen the maturity profile of domestic debt by issuing more longer-dated treasury instruments.

1.5. Conclusion

While Uganda's economy remains fundamentally sound, the direction of global economic and financial risks poses potential threats to financial stability. Trends in the global financial markets could result in higher interest rates and increase the costs for external financing.

2. Key Developments In Uganda's Banking Sector

2.1. Growth of the banking sector

The banking sector registered increased growth in the year to June 2017. Total assets of commercial banks grew by 9.0 percent between June 2016 and June 2017, up from 5.5 percent in the previous year (see Table 4). The increase in assets was mainly driven by banks' increased holdings of securities, amidst a shift away from loans, which recorded sluggish growth.

Banks' holdings of BOU securities[5] increased four-fold, from USh.0.5 trillion at June 2016 to USh.2.0 trillion at June 2017. Banks also increased their holdings of central government securities by 3.5 percent, from USh.5.0 trillion at June 2016 to USh.5.1 trillion at June 2017. However, this growth rate was lower than that recorded in the year to June 2016 of 15.9 percent. This was attributed to a slowdown in the issuance of central government securities from 14.7 percent growth in the year to June 2016 to 3.4 percent growth in the year to June 2017.

Table 4: Annual changes in banks' assets

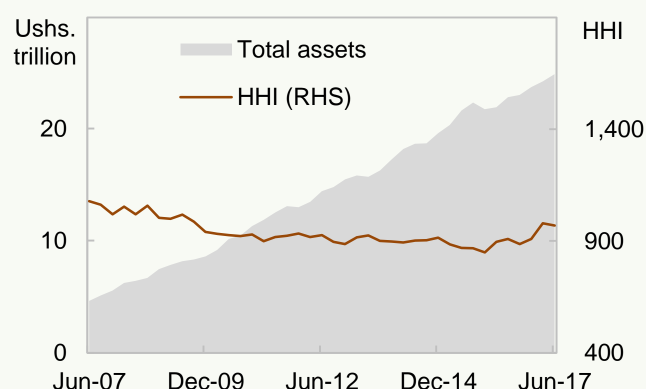
	Jun-14	Jun-15	Jun-16	Jun-17
Total assets				
Values (USh. trillion)	18.6	21.6	22.8	24.8
Growth (%)	18.8	15.9	5.5	9.0
Central Government securities				
Values (USh. trillion)	4.0	4.3	5.0	5.1
Growth (%)	29.6	6.1	15.9	3.5
BOU securities				
Values (USh. trillion)	0.9	0.2	0.5	2.0
Annual growth (%)	64.1	-79.4	141.7	347.0
Loans				
Values (USh. trillion)	8.8	10.5	10.9	11.0
Annual growth (%)	14.4	19.7	3.7	0.9

[5] Balances from repurchase agreements (Repos) and the Deposit Facility, which are later on defined in Section 2.3 of this report.

Source: Bank of Uganda

Analysis of the banking sector's market concentration[6] using the Herfindahl-Hirschman Index (HHI)[7] revealed that the sector remains highly competitive. The HHI of Uganda's banking sector increased from 909.3 at June 2016 to 969.4 at June 2017 (see Chart 20). The increase shows that growth within the sector was concentrated in fewer banks at June 2017 compared to June 2016. This was mainly attributed to the closure and subsequent sale of Crane Bank assets to DFCU Bank, whose contribution to the HHI increased from 47.8 at June 2016 to 148.8 at June 2017. The HHI remains below the threshold of 1000, signifying a highly competitive banking sector.

Chart 20 : Evolution of the Ugandan banking sector's market concentration



Source: Bank of Uganda

2.2. Capital adequacy

Overall, the banking sector remained well capitalised in the year to June 2017. All commercial banks met the minimum core and total capital adequacy ratios of

[6] In the case of Uganda's banking sector, we use the share of a bank's assets as a proxy for market share.
[7] The Herfindahl-Hirschman Index (HHI) is a commonly accepted measure of market concentration. HHI is calculated as the sum of squares of the market shares of all firms in a sector. HHI below 1000 indicates a highly competitive industry while HHI below 1500 indicates an industry that is not concentrated.

8.0 percent and 12.0 percent respectively. The industry's aggregate tier one capital adequacy ratio and the total regulatory capital adequacy ratio increased from 19.0 percent and 21.7 percent at June 2016 to 21.4 and 23.6 percent at June 2017 respectively (see Table 5). The leverage ratio (ratio of regulatory tier 1 capital to total assets plus off-balance sheet items), which is another indicator of banks' capital adequacy, also increased from 10.8 percent at June 2016 to 11.5 percent at June 2017.

Table 5: Banks' aggregate capital adequacy ratios (percent)

	Jun-14	Jun-15	Jun-16	Jun-17
Total capital adequacy ratio	22.8	21.2	21.7	23.6
Tier 1 capital adequacy ratio	20.3	18.8	19.0	21.4
Leverage ratio	11.2	11.0	10.8	11.5

Source: Bank of Uganda

Banks' total shareholders' capital increased from USh.3.7 trillion at June 2016 to USh.4.2 trillion at June 2017. This was as a result of an increase in share premium of 117.5 percent, due to DFCU's issue of shares to finance the acquisition of Crane Bank's assets. The increased capital base was also supported by a 43.1 percent increase in profits for the first half of 2017.

2.3. Funding and liquidity conditions

Uganda's commercial banks fund their assets mainly through retail deposits, wholesale market funds and equity. In the year to June 2017, banks recorded increased growth across all three sources of funding thus strengthening their funding base. By analysing changes in the banking sector's stable funding sources, we are able to determine whether there exist maturity mismatches between key assets and liabilities which would render the sector's core business activities unsustainable.

Table 6 shows that annual changes in core funding exceeded the annual increase in key assets by USh.416.7 billion at the end of June 2017. The computation of the funding gap provided in the table assumes that for banks, retail deposits are the major source of funds for core assets. It can be seen that for the year ending June 2017, banks were able to cover growth in key assets with increased deposits only; mainly as a result of a slowdown in lending. This increased the availability of wholesale funds within the domestic market; which together with an increase in retained earnings provided the industry with a funding surplus of USh.416.7 billion. Given the surplus funding from the stable retail deposits, there are low risks from balance sheet mismatches arising from operations in the year to June 2017.

Table 6: Annual changes in core funding sources and core assets (USh. billion)

	Jun-14	Jun-15	Jun-16	Jun-17
Deposits	2021.1	2044.5	1087.3	1603.6
LESS (key assets):				
Loans	1106.5	1733.7	389.7	101.9
Securities	918.1	246.3	682.2	1377.5
Due from resident institutions	3.3	86.8	194.7	10.2
Due from non-resident institutions	-312.3	841.8	-44.8	-11.4
Cash assets	69.7	149.4	-40.3	111.2
	235.8	**-1013.4**	**-94.2**	**14.2**
ADD (wholesale funding):				
Due to resident institutions	307.5	-177.4	-194.7	72.4
Due to non-resident institutions	142.8	-127.0	34.3	-4.6
	686.1	**-1317.8**	**-254.6**	**82.0**
ADD (equity component):				
Retained earnings	197.6	306.9	295.1	334.7
Funding gap	**883.7**	**-1010.9**	**40.5**	**416.7**

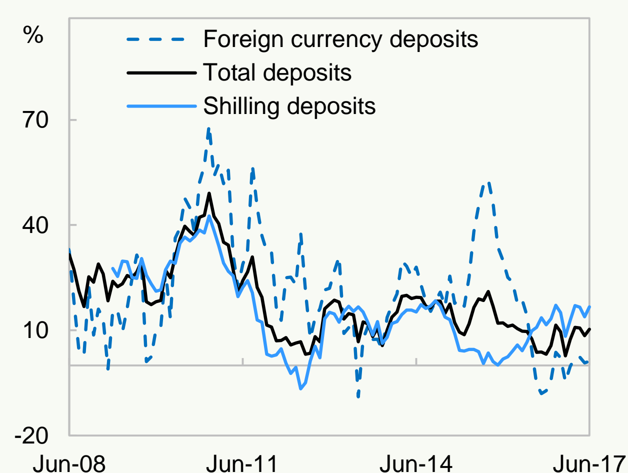
Source: Bank of Uganda

Funding conditions

Among the major funding sources, retail deposits grew by 10.3 percent in the year to June 2017, compared to 7.5 percent in the year to June 2016.

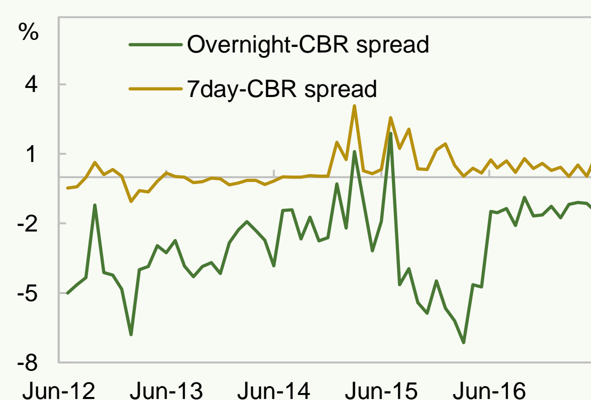
Deposit growth was driven by local currency deposits which grew by 16.6 percent in the year to June 2017, compared to 9.9 percent in the year to June 2016. The growth in local currency deposits was reflected across all deposit types, particularly savings and time deposits. Foreign currency deposits, on the other hand, recorded sluggish growth, increasing by only 1.2 percent in the year to June 2017, compared to 4.3 percent in the year to June 2016.

Chart 21: Annual growth in banks' retail deposits (percent)



Source: Bank of Uganda

Chart 22: Spreads between interbank rates and the central bank rate (percent)



Source: Bank of Uganda

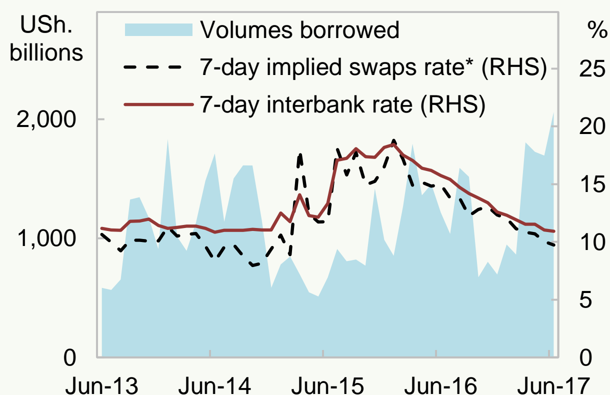
In the wholesale market[8], banks' borrowing increased in the year to June 2017. Risks from wholesale funding, however, remained minimal as banks' reliance on wholesale funds remained low. Additionally, the volatility of interest rates in the interbank market, particularly rates on overnight trading, was subdued in the year to June 2017 (see Chart 22).

Total unsecured borrowing in the interbank market increased by 0.4 percent, from USh.22.6 trillion in the year to June 2016 to USh.22.7 trillion in the year to June 2017. The weighted average rates on overnight and 7-day interbank transactions declined from 13.5 percent and 15.7 percent at June 2016 to 8.5 percent and 10.9 percent at June 2017 respectively. These changes reflected the easing of monetary policy, as the central bank rate (CBR) declined from 15.0 percent in June 2016 to 10.0 percent in June 2017.

Despite increased interbank activity, the ratio of interbank borrowings to total deposits remained low at 2.0 percent in June 2017, signifying banks' low reliance on wholesale funds compared to retail deposits. Solvency risk due to counterparty default in the interbank market was also low as indicated by the ratio of outstanding interbank exposure to core capital of 9.6 percent as at June 2017.

[8] The wholesale market includes unsecured borrowing in the domestic interbank market and borrowing in the foreign currency swaps market.

Chart 23: Monthly rates and volumes borrowed in local currency from the swaps market



Source: Bank of Uganda

**An implied currency swaps rate is the cost of funds that a lending counterparty in a swaps transaction attaches to its funds in determining the forward exchange rate for a given currency swap. It is referred to as implied because it is unobservable, but is inferred from the forward and spot exchange rates of given market transactions.*

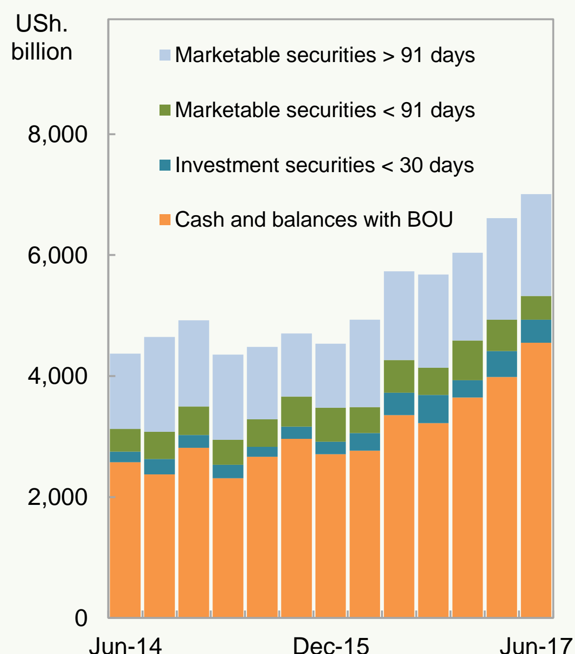
Borrowing activity through currency swaps increased by 12.4 percent, from USh.13.7 trillion borrowed in the year to June 2016 to USh.15.4 trillion borrowed in the year to June 2017. The average implied overnight and 7-day rates declined from 13.2 percent and 15.0 percent at June 2016 to 8.9 percent and 9.7 percent at June 2017 respectively. While the declining interest rates encouraged borrowing, there was also marked increase in commercial banks borrowing from the major offshore counterparty banks (see Chart 23). The largest volumes of transactions are undertaken with parent and sister offshore banks in the United Kingdom and South Africa.

Bank liquidity

Banks maintained adequate liquidity buffers well above the regulatory minimum requirements, thus keeping liquidity risk low. The build-up of excess liquidity in the banking industry partly reflected the slowdown in lending by commercial banks.

The liquid assets-to-total deposits ratio rose from 43.4 percent in June 2016 to 50.1 percent in June 2017, more than double the regulatory minimum requirement of 20.0 percent. The Liquidity Coverage Ratio (LCR) for the aggregate industry balance sheet stood at 252.9 at June 2017, compared to 188.4 at June 2016. This was because the stock of high-quality liquid assets increased by 35.7 percent, of which over 60.0 percent comprised of cash and balances with BOU. Banks' liquidity management also improved over the year as the deficit on the short-term gap[9] reduced to an all-time low[10] of 3.7 percent in March 2017, due to increased investments in the short-term BOU securities.

Chart 24: Evolution of the stock of high-quality liquid assets held by banks (USh. billion)



Source: Bank of Uganda

---

[9] Short-term gap is measured as the difference between short-term assets and short-term liabilities, scaled by total assets.
[10] Data on the indicator is available from March 2000.

BOX 1: Banks' liquidity and the central bank's open market operations

BOU has a number of tools at its disposal to implement monetary policy. These include tools to mop up or inject liquidity into the financial system through commercial banks, in order to align interbank lending rates with the policy rate, the central bank rate (CBR). BOU uses vertical repurchase agreements (repos), the deposit facility and secondary market sales of Government securities, to mop up excess liquidity from the system. It uses vertical reverse repos, and occasionally secondary market purchases of Government securities, to inject liquidity into the system.

A repurchase agreement (repo) is a form of short-term borrowing that is secured using government securities. The deposit facility issued by BOU is more long-term than the repo, with standardized maturities of 28 days or 56 days, and involves BOU offering interest-bearing term deposits to commercial banks through an auction. The deposit facility was re-introduced in November 2016 to compliment the repos in enabling BOU to deal with increases in structural liquidity. It also enables BOU to mop-up liquidity for longer maturities.

In the year to June 2017, BOU intensified its open market operations to mop up excess liquidity worth USh.38.5 trillion through vertical repos and USh.2.6 trillion through the deposit facility. This was almost three times the amount mopped up in the year to June 2016 (see Table 7). Large liquidity positions in the banking system partly reflect the slowdown in credit growth in the year to June 2017, along with Government borrowing from the BOU. Banks are expected to remain very liquid in the short term, amidst slow recovery in credit growth.

Table 7: Volumes of BOU open market transactions (USh. trillion)

	Jun-13	Jun-14	Jun-15	Jun-16	Jun-17
Repos	13.4	26.7	17.1	13.9	38.5
Reverse repos	NA	NA	2.6	3.3	0.8
Deposit facility	-	NA	NA	NA	2.6

Source: Bank of Uganda

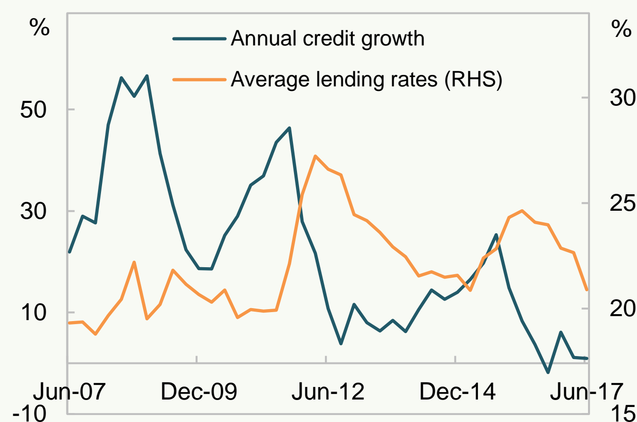
2.4. Banks' lending activity

Overall credit growth from the banking industry slowed down in the year to June 2017. Total outstanding credit increased by 0.9 percent between June 2016 and June 2017, far lower than 3.7 percent growth recorded in the year to June 2016 and 19.7 percent credit growth recorded in the year to June 2015. In terms of currency denomination, shilling loans grew by 6.5 percent in the year to June 2017, compared to 5.8 percent in the year to June 2016. On the other hand, foreign currency-denominated loans fell by 5.9 percent. The ratio of foreign currency loans to total loans therefore decreased from 45.1 percent at June 2016 to 42.1 percent at June 2017.

Credit growth in the year to June 2017 declined mainly due to increased risk aversion by banks. BOU's quarterly Bank Lending Survey reports for the year to June 2017 indicated that banks' lending standards tightened during that period, owing to high default rates, particularly from large enterprises, deliberate efforts to improve and maintain the quality of the loan book, and a slowdown in real output growth. The contraction in lending was further revealed in the level of gross credit extensions which

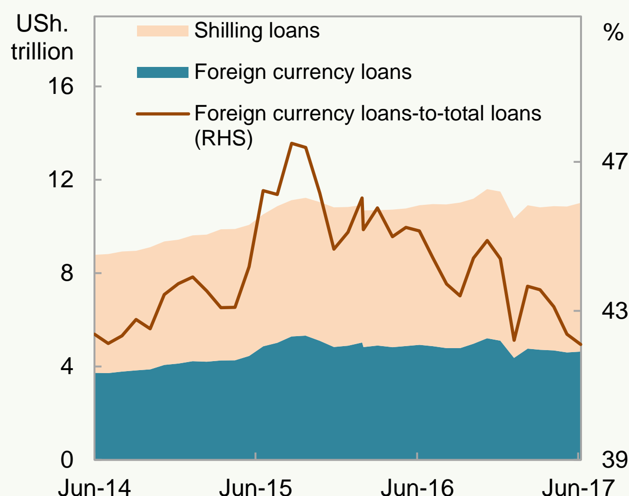
dropped to a 3-year low of USh.1,848.0 billion for the quarter ending March 2017.

Chart 25: Evolution of aggregate bank credit and average lending rates (percent)



Source: Bank of Uganda

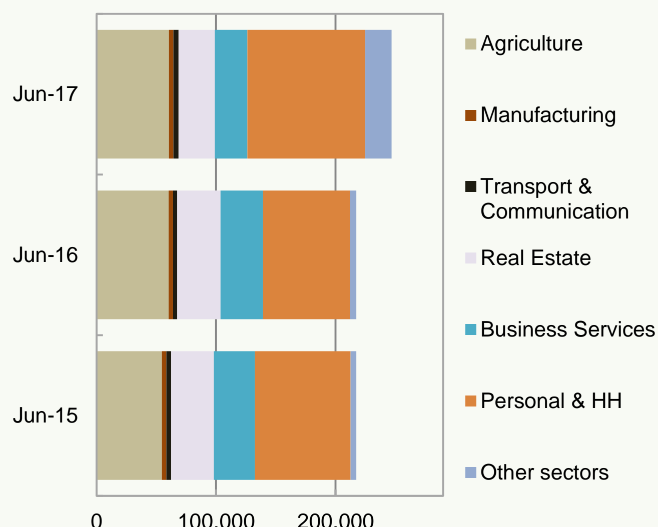
Chart 26: Stock of loans by currency denomination



Source: Bank of Uganda

Demand for credit however strengthened, as the total number of loan applications to banks increased by 6.4 percent in the year to June 2017, compared to 0.5 percent in the year to June 2016. Demand for credit increased across various economic sectors (see Chart 27) and could have been largely influenced by declining interest rates; the weighted average lending rate decreased from 23.5 percent at June 2016 to 21.1 percent at June 2017.

Chart 27: Number of annual loan applications per business sector



Source: Bank of Uganda

Based on strong deposit growth, favourable movements in interest rates, and the projected increase in real output growth, banks' lending standards are expected to ease in the year to June 2018.

Changes in sectoral lending

In the year to June 2017, credit to the real estate, manufacturing and transport and communications sectors contracted on account of decreased lending and significant write-offs in these sectors. However, increased credit growth was registered in the trade and commerce, agriculture and household sectors (see Table 8).

Notably, growth in household sector loans was 8.4 percentage points higher than the five-year historical average level, which propelled the sector's share of loans to 18.5 percent. Given the growth in the household sector's loan book, coupled with slower lending activity and low asset quality in other sectors, banks should ensure that total household debt levels are backed up by adequate income sources.

Table 8: Analysis of sectoral lending by banks (percent)

		*5-yr average	Jun-15	Jun-16	Jun-17
Agriculture	Share	8.1	9.3	9.8	11.3
	Growth rate	22.8	21.3	9.3	17.1
Manufacturing	Share	14.3	16.1	14.6	13.3
	Growth rate	18.5	40.6	-5.5	-8.1
Trade & Commerce	Share	19.7	19.5	17.9	18.9
	Growth rate	6.3	12.8	-4.9	6.4
Real Estate & Construction	Share	23.0	23.2	23.6	20.5
	Growth rate	18.8	19.8	5.2	-12.2
Business Services	Share	4.5	4.7	3.7	4.2
	Growth rate	17.7	29.2	-18.6	14.0
Personal & Household Loans	Share	15.6	15.2	15.9	18.5
	Growth rate	8.6	5.1	8.4	17.0
Transport & Communication	Share	6.0	5.2	7.1	6.8
	Growth rate	7.4	15.6	43.1	-3.5

Source: Bank of Uganda

**The statistics are computed for 5 years to June 2016. In the case of growth rates, the median was used instead of an average as a result of the skewed distribution of growth rates in some sectors, particularly the trade and commerce, transport and communication and household sectors.*

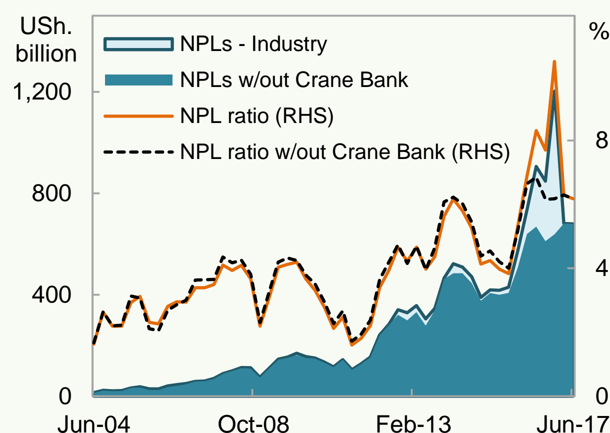
2.5. Asset quality

Indicators of banks' asset quality revealed that the build-up of credit risk to the sector remained a concern in the year to June 2017. While the ratio of non-performing loans to total gross loans (NPL ratio) decreased from 8.3 percent to 6.2 percent between June 2016 and June 2017, improvement in asset quality was hampered by significant write-offs and further deterioration of existing NPLs.

The decline in the NPL ratio resulted from a 43.5 percent reduction in NPLs between December 2016 and June 2017. The drop in NPLs within this period was attributed to two major factors: the closure of Crane Bank, whose NPLs contributed to 46.9 percent of industry-wide NPLs by the end of December 2016; and significant write-offs by banks which peaked in the quarter to March 2017 (see Chart 29).

Excluding Crane Bank from the aggregated balance sheet reveals that the NPLs for all the other banks actually increased slightly from USh.668.7 billion at June 2016 to Ush.679.6 billion at June 2017 (see Chart 28). The NPL ratio, however, reduced from 6.8 percent to 6.2 percent during this period as the rate of credit growth, despite being slow, surpassed the rise in NPLs.

Chart 28: Evolution of banks' NPLs



Source: Bank of Uganda

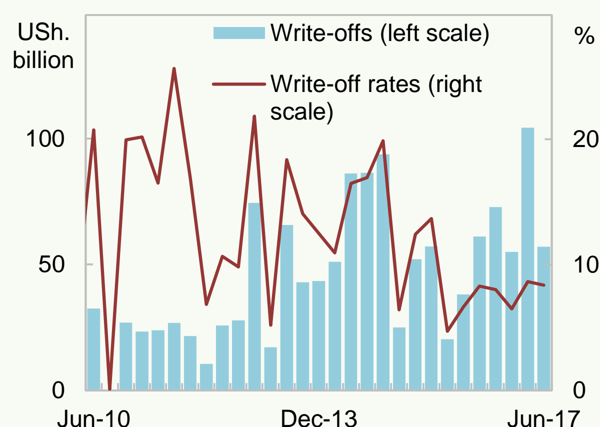
Banks' total credit write-offs increased by USh.112.5 billion, from USh.176.6 billion in the year to June 2016 to USh.289.1 billion in the year to June 2017, although write-off rates[11] remained lower than historical average levels (see Chart 29). Furthermore, analysis of loan classification in the year to June 2017 indicated increased credit risk as watch loans continued to rise and existing NPLs deteriorated further into sub-standard and doubtful categories (see Chart 30).

---

[11] Write-off rates are calculated as write-offs in the current quarter divided by the previous quarter's NPLs, expressed as a percentage.

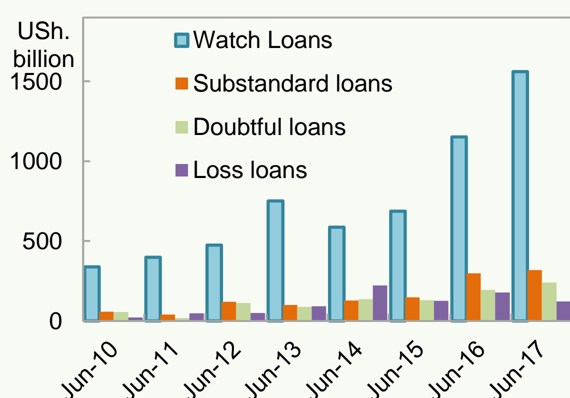
Given the level of existing NPLs in the industry relative to historical levels, any further deterioration in banks' loan portfolio is likely to drive up write-off rates in the short- to medium-term.

Chart 29: Quarterly bank write-offs



Source: Bank of Uganda

Chart 30: Classification of banks' NPLs, excluding Crane Bank



Source: Bank of Uganda

Asset quality by currency

Both the local currency and foreign currency industry NPL ratios decreased between June 2016 and June 2017 (see Table 9). Shilling-denominated NPLs declined by 25.7 percent; from USh.495.9 billion in June 2016 to USh.305.0 billion in June 2017. Similarly, foreign currency-denominated NPLs declined by 25.7 percent, from USh.410.3 billion in June 2016 to USh.305.0 billion in June 2017.

Table 9: NPL ratios by currency (percent)

		*4 yr-average	Jun-15	Jun-16	Jun-17
Industry	Overall	5.9	4.0	8.3	6.2
	USh.	6.0	3.8	8.3	5.9
	FX.	5.7	4.2	8.3	6.6
Agriculture	Overall	10.2	6.2	17.4	12.5
	USh.	6.5	4.6	11.8	9.3
	FX.	13.2	7.5	21.9	15.1
Manufacturing	Overall	2.9	4.3	2.3	2.7
	USh.	5.2	7.8	6.0	5.2
	FX.	1.8	2.7	0.6	1.3
Trade & commerce	Overall	6.8	3.7	9.1	5.5
	USh.	7.8	2.6	10.8	7.0
	FX.	5.3	5.2	7.0	3.5
Real Estate & Construction	Overall	6.0	3.6	11.1	4.7
	USh.	6.8	2.6	11.6	6.0
	FX.	5.2	4.0	10.7	3.4
Personal & Households	Overall	3.6	4.1	3.4	4.2
	USh.	3.5	4.0	3.8	4.2
	FX.	5.2	5.7	1.9	2.3
Transport & Communication	Overall	7.1	6.0	11.0	9.3
	USh.	7.0	7.7	15.6	3.1
	FX.	7.7	5.1	7.0	16.9
Mining & Quarrying	Overall	12.0	7.2	0.8	31.5
	USh.	17.3	0.0	1.7	17.5
	FX.	9.3	18.9	0.1	38.9
Business Services	Overall	5.3	2.7	2.1	14.6
	USh.	5.7	3.5	3.3	10.4
	FX.	4.5	1.6	0.1	21.4

Source: Bank of Uganda

* *The averages are computed for 4 years to June 2016.*

Loan performance by sector

NPL ratios for the agriculture, trade and commerce, building and construction and transport and communication sectors declined within the period under review (see Table 9). The manufacturing sector's NPL ratio increased, but remained lower than 4-year average ratios.

The household sector, however, registered its highest NPL ratio in the past 4 years. In absolute terms, the NPLs of the household sector increased by 34.6 percent, from USh.3.7 billion to USh.4.2 billion. Given the increasing trend in lending to the

households and the deteriorating asset quality, there exists increased potential credit risk from this sector.

2.6. Earnings and profitability

Profitability of the banking industry reduced in the year to June 2017, mainly due to increased provisioning and an overall rise in operating costs. On the income side, net interest margins widened, driven by interest incomes from increased investment in government securities and reduced interest expenses, and despite the drop in income from loans and advances.

Banks' aggregate net after-tax earnings declined by 16.7 percent, from USh.485.6 billion in the year to June 2016 to USh.404.5 billion in the year to June 2017. The decline was mainly a result of increased costs, particularly through provisioning for bad debt which increased by 14.5 percent, from USh.364.1 billion in the year to June 2016 to USh.531.1 billion in the year to June 2017. However, 42.0 percent of provisions for bad debt were attributed to Crane Bank. Excluding Crane Bank's incomes and expenses, banks' aggregate net after-tax earnings increased by 6.1 percent from USh.573.5 billion in the year to June 2016 to USh.608.3 billion in the year to June 2017.

Table 10: Indicators of commercial banks' profitability (year-on-year analysis)

	5-yr average	Jun-14	Jun-15	Jun-16	Jun-17
Net profit after tax (USh. billion)	460.7	358.8	556.3	485.6	404.5
ROA (%)	2.4	2.1	2.8	2.2	1.7
ROE (%)	15.0	12.8	17.7	13.8	10.2
Number of loss-making banks	7	8	7	5	6
Net interest margin (%)	11.8	11.5	10.9	11.9	12.4
Cost-to-income ratio (%)	77.6	81.8	73.8	78.4	81.6
Overhead-to-income ratio (%)	47.1	47.9	48.1	47.9	48.4

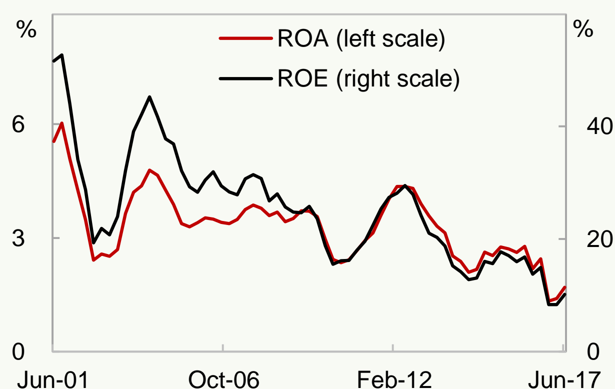
Source: Bank of Uganda

On the income side, banks recorded a drop in interest income on loans and advances, by 0.7 percent, during this period. However, interest earned on government securities increased by 26.8 percent, while income on other asset categories grew by 32.0 percent as a result of increased investment in central bank securities.

Analysis of profitability ratios

The aggregate return on assets (ROA) and return on equity (ROE) dropped from 2.2 percent and 13.8 percent at June 2016 to 1.7 percent and 10.2 percent at June 2017 respectively. The long-term trends of ROA and ROE show that the profitability of Uganda's banking industry has generally been declining (see Chart 31). As such, the DuPont analysis was performed to further investigate the drivers of weakened profitability in the banking industry in the last fifteen years (see Box 2). The results showed that over the years, ROA and ROE of the banking industry have mainly been affected by decreasing net profit margins, an indication of decreasing cost efficiency. In the year to June 2017, however, the profitability ratios were affected by both weakened net profit margins and turnover of assets mainly due to reduced asset quality.

Chart 31: Evolution of aggregate profitability ratios (percent)



Source: Bank of Uganda

As banks clean up their loan portfolios through writing off bad debt, it is expected that both net profit

margins and asset utilisation will improve. Going forward, therefore, a rebound to profitability for banks will depend on improvements to the quality of their loan books.

BOX 2: Decomposition of profitability ratios using DuPont analysis

Du-Pont analysis is a common form of financial statement analysis, which decomposes the return on equity (ROE) ratio to determine the underlying drivers of profitability within the financial statements of companies. The DuPont analysis can also be applied to return on assets (ROA).

Using the DuPont analysis, ROE and ROA, which are mixed financial statement ratios, can be decomposed into both income statement and balance sheet ratios. This enables analysts to identify the strengths, weaknesses and potential areas for improvement in profitability, within the financial statements.

ROE can be decomposed into three ratios. The first is the **net profit margin**, an indicator for cost efficiency which shows how efficient a company is at converting its revenue streams into profits. The second is the **asset turnover ratio**, an indicator of asset utilisation which shows the efficiency with which a company deploys its assets to generate revenue. The third is the **equity multiplier**, an indicator of financial leverage which shows the proportion of total assets financed by shareholders. This decomposition of ROE is much clearer when presented mathematically:

$$\text{ROE} = \frac{\text{Net income}}{\text{Average Total Equity}} = \underbrace{\frac{\text{Net Income}}{\text{Revenue}}}_{\text{Net profit margin}} \text{ x } \underbrace{\frac{\text{Revenue}}{\text{Average Total Assets}}}_{\text{Asset turnover ratio}} \text{ x } \underbrace{\frac{\text{Average Total Assets}}{\text{Average Total Equity}}}_{\text{Equity multiplier}};$$

Where the first term is the net profit margin, the second term is asset turnover and the third term is the equity multiplier.

The decomposition implies that a company can increase its ROE by simply increasing any one of the above three components, while keeping others constant. For example, ROE can be increased by increasing the equity multiplier. The higher the equity multiplier, the more highly leveraged a company is, and thus the higher the potential for a company to increase its asset base and generate revenues and profits, without necessarily utilising/increasing shareholders' equity. However, increased leverage as the sole driver for return on equity can be unsustainable as it increases financing costs and can therefore have a negative effect on net profit margins. Increased leverage should hence be complimented by increased generation of revenues from assets (asset turnover) and increased cost efficiency in order to turn revenues generated by assets into profits at lower costs (net profit margins). The three ratios therefore provide indications as to whether a company's profitability is sustainable.

In a similar way, ROA can be decomposed into two ratios, one income statement ratio and one balance sheet ratio. These include: the **net profit margin** and the **asset turnover ratio**. Mathematically, this is presented as follows:

$$ROA = \frac{\text{Net income}}{\text{Average Total Assets}} = \underbrace{\frac{\text{Net Income}}{\text{Revenue}}}_{\text{Net profit margin}} \times \underbrace{\frac{\text{Revenue}}{\text{Average Total Assets}}}_{\text{Asset turnover ratio}};$$

where the first term is the net profit margin and the second term is asset turnover.

Application to Uganda's banking system

The DuPont analysis was performed for Uganda's aggregate banking system in order to ascertain the drivers of weakened profitability. The decomposition showed that over time, both ROE and ROA of the banking industry have mainly been affected by decreasing net profit margins; while asset turnover has oscillated between 12.2 percent and 18.4 percent (see Chart 32). The decreasing net profit margins are an indicator that the cost efficiency of banks has generally decreased over time, which has affected profitability levels.

The decomposition also shows that since 2001, the equity multiplier has had two periods of declining levels (2004 – 2009 and 2010 – 2012), indicating increased equity levels as a proportion of assets. These have coincided with regulatory changes on increased capital buffers (Financial Institutions Act, 2004 and revision of minimum capital requirements, 2010). However, periods before these regulatory changes were characterised by increasing equity multipliers and profitability ratios.

Between June 2016 and June 2017, ROE and ROA were affected by both decreased net profit margin and decreased asset turnover (see Chart 33). The industry's net profit margin declined by 2.3 percent mainly as a result of increased provisioning for bad debt. Asset turnover declined by 3.5 percent as revenue growth was affected by poor asset quality, which resulted in decreasing interest income from loans and advances. An increase in equity as a proportion of assets also had a negative impact on banks' ROE as the equity multiplier decreased from 6.2 percent at June 2016 to 5.9 percent at June 2017. The decomposition also reveals that while asset turnover increased in the year to June 2016, net profit margins declined thus affecting profitability. The steep increase in banks' NPLs, which started in December 2015 (see Chart 28) had a contemporaneous effect on net profit margins in the year to June 2016 as a result of increased provisioning, However, the negative effects on asset turnover were lagged, and only fully materialised in the year to June 2017.

Chart 32: Decomposition of banks' return on equity

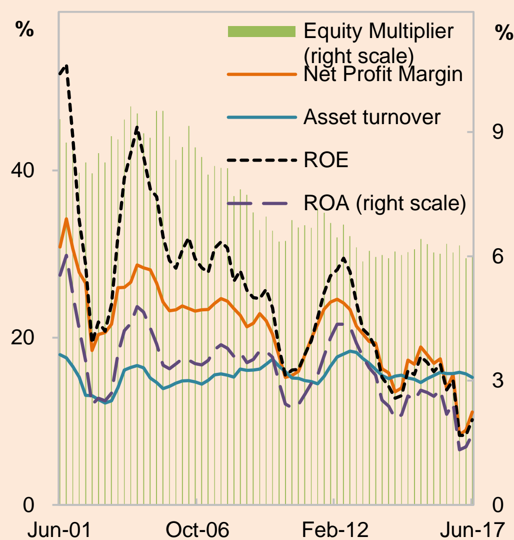
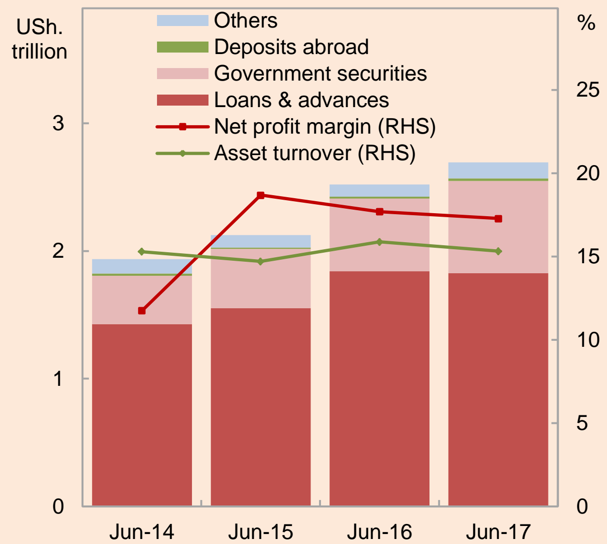


Chart 33: Banks' interest income and decomposition of return on assets



Source: Bank of Uganda

Over the long term, a rebound to higher profitability levels for the industry hinges on increased cost efficiency, particularly through reducing operational fixed costs. While the equity multiplier might be somewhat restrained by regulation, its effect on ROE indicates that banks whose capital structure entails extremely high equity positions, relatively lower deposits mobilisation and less investment in higher yielding assets (more securities and less loans) would be less profitable than their counterparts in the industry. Sufficient equity levels to meet regulatory requirements, coupled with increased deposits mobilisation and good asset quality, whose revenues adequately cover operational costs, are essential to profitability improvement.

2.7. Performance of domestic systemically important banks (DSIBs)

Three commercial banks were identified as domestic systemically important banks (DSIBs)[12] at the end of June 2017; ***Stanbic Bank, Standard Chartered Bank*** and ***DFCU Bank***, during which period they accounted for 42.8 percent of total bank assets.

Overall, the DSIBs strengthened their balance sheets through increasing their regulatory capital as a percentage of risk-weighted assets. Deposit growth increased amidst a decreasing interest rate environment, and deposits retained an overwhelmingly large share of liabilities to provide DSIBs with a strong funding base. At an aggregate level, asset quality for DSIBs improved over the year to June 2017, in comparison to the year to June 2016. However, their profitability reduced as a result of decreased interest income growth from loans. Overall, despite the decreased profitability, the build-up of capital buffers increased the resilience of DSIBs.

Capital adequacy

The DSIBs were adequately capitalised as at the end of June 2017. All three banks met the minimum regulatory requirements for both the total capital and core capital adequacy ratios. The aggregate total capital adequacy ratio of the DSIBs increased from 19.3 percent in June 2016 to 20.8 percent in June 2017, while the core capital adequacy ratio increased from 15.8 percent in June 2016 to 18.3 percent in June 2017.

Funding and liquidity

As at June 2017, DSIBs maintained adequate funding bases supported by retail deposits and held sufficient liquid assets to keep liquidity risk low. Total deposits for DSIBs accounted for 78.4 percent of their total liabilities, while deposit growth increased from 10.8 percent in the year to June 2016, to 25.4 percent in the year to June 2017. DSIBs also recorded increased borrowing activity in the wholesale funds markets during the year to June 2017, accounting for 34.8 percent of unsecured borrowing activity in the interbank and 49.4 percent of borrowing activity in the swaps market. Unsecured borrowing in the interbank market by the DSIBs increased to Ush.7.9 trillion in the year to June 2017, from USh.5.6 trillion in the year to June 2016; while borrowing in the swaps market increased to USh.7.6 trillion, from USh.4.6 trillion in the year to June 2016.

The monthly Liquidity Coverage Ratio (LCR) results for June 2017 indicated that each individual DSIB held sufficient total liquid assets to sustain the bank through a 30-day stress period. The three banks' aggregate LCR stood at 230.8 percent during this period, well above the recommended minimum requirement of 100 percent. Their ratio of liquid assets to total deposits stood at 49.4 percent in June 2017, an increase from 44.5 percent at June 2016.

[12] Domestic systemically important banks (D-SIBs) are defined as banks whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness would cause significant disruption to the wider financial system and economic activity.

Table 11: Comparison of selected financial soundness indicators of DSIBs to aggregate industry indicators (percent)

	Jun-15		Jun-16		Jun-17	
	DSIBs	Industry	DSIBs	Industry	DSIBs	Industry
Total DSIBS assets to total industry assets	37.3	N/A	38.2	N/A	42.8	N/A
Total capital adequacy ratio	18.9	21.3	19.3	21.7	20.8	23.6
Tier 1 capital adequacy ratio	15.8	18.8	15.8	19.0	18.3	21.4
Liquidity Coverage Ratio	237.3	354.4	138.6	188.4	230.8	252.9
Liquid assets to total deposits	47.6	46.4	44.5	43.4	49.4	50.1
NPLs-to-total gross loans ratio	5.9	4.0	9.1	8.3	5.9	6.2
Return on assets	3.7	2.8	3.3	2.2	3.2	1.7
Return on equity	28.2	17.7	24.3	13.8	21.0	10.2

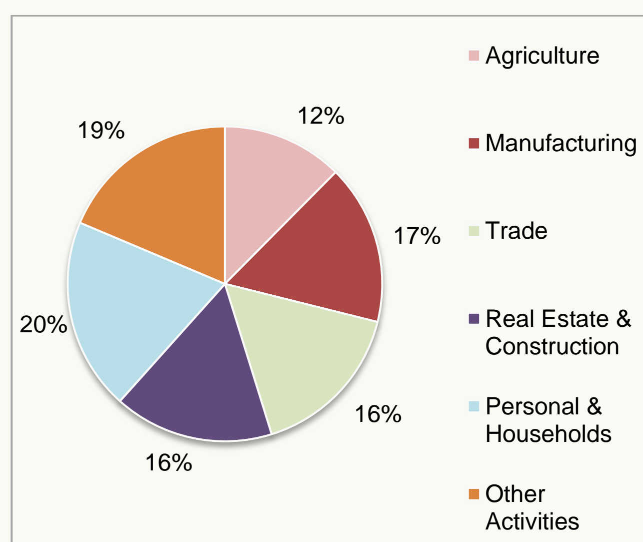
Source: Bank of Uganda

Lending

DSIBs reported increased lending activity, amidst sluggish credit growth across the industry. Total outstanding credit increased by 14.2 percent in the year to June 2017, in comparison to a decline in credit of 1.4 percent in the year to June 2016. Their aggregate ratio of foreign currency loans to total loans dropped, from 49.5 percent in June 2016 to 44.3 percent in June 2017, 2.2 percentage points higher than the industry level. DSIBs accounted for 41.6 percent of total loans and 43.4 percent of foreign currency loans in the banking industry at June 2017.

As at the end of June 2017, the DSIBs' credit exposure was mainly to the household sector, manufacturing sector, building and construction sector, trade and commerce sector and the agriculture sector. Credit to the agriculture sector increased by 43.5 percent, while credit to the trade and commerce sector by 42.3 percent.

Chart 34: Sectoral allocation of credit by DSIBs as at end-June 2017 (percent)



Source: Bank of Uganda

Asset quality

The asset quality of DSIBs improved between June 2016 and June 2017, as a result of increased write-offs during the year. The aggregate NPL ratio for the DSIBs decreased from 9.1 percent at June 2016 to 6.0 percent at June 2017. Aggregate NPLs decreased by USh. 90.7 billion, from USh.364.2 billion at June 2016 to USh.273.5 billion at June 2017. However, DSIBs reported a total of USh.166.0 billion in write-offs during the year to June 2017, accounting for 57.4 percent of industry wide write-offs.

Earnings and profitability

The profitability of DSIBs declined in the year to June 2017. The return on assets decreased from 3.3 percent in the year to June 2016 to 3.2 percent in the year to June 2017, while the return on equity decreased from 24.3 percent in the year to June 2016 to 21.0 percent in the year to June 2017.

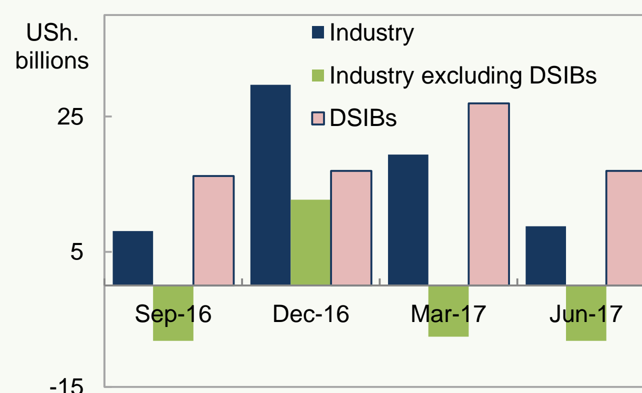
Relative to the industry, return on assets and return on equity for DSIBs was 1.5 and 10.8 percentage points higher. The share of DSIBs' total income stood at 41.0 percent in the year to June 2017 (see Table 12), in line with their share of assets in the industry. However, their share of net profits after taxes stood at 75.8 percent of the industry's net profits after taxes. Analysis of the expenses indicates that the DSIBs share of provisions for bad debt stood at only 25.7 percent of the industry provisions, despite the high proportion of industry NPLs. A review of shortfalls in provisions shows that DSIBs provisioned much less in comparison to the industry (see **Error! eference source not found.**). Risks to a rebound in profitability therefore exist from the shortfalls in DSIBs' provisions for NPLs.

Table 12: DSIBs share of profitability relative to the Industry (percent)

	Jun-15	Jun-16	Jun-17
Total gross income	39.5	39.3	41.0
Total expenses	34.9	35.9	36.4
Provisions for bad debt	50.1	27.3	25.7
Net profit after taxes	49.0	57.3	75.8

Source: Bank of Uganda

Chart 35: DSIBs' shortfall in provisions in the year to June 2017



Source: Bank of Uganda

2.8. Performance of other deposit-taking financial institutions

Other deposit-taking financial institutions in Uganda's financial sector include credit institutions (CIs) and microfinance deposit-taking institutions (MDIs).

Credit institutions

Overall, the CIs were adequately capitalised as at June 2017. The overall core capital adequacy ratios increased from 22.4 percent at June 2016 to 24.3 percent at June 2017, while the total capital adequacy ratio increased from 24.2 percent at June 2016 to 26.0 percent at June 2017.

CIs registered increased growth in assets, albeit, at a subdued rate. Asset growth declined from 20.5 percent in the year to June 2016 to 12.6 percent in the year to June 2017. This was attributed to a slowdown in credit growth, from 17.2 percent recorded in the year to June 2016 to 10.2 percent in the year to June 2017. Indicators showed that liquidity for CIs improved as liquid assets to total deposits increased from 51.8 percent at June 2016 to 53.1 percent at June 2017. However, deposit growth reduced to 14.5 percent in the year to June 2017, down from 21.7 percent in the year to June 2016. This was mainly on account of savings deposits,

which grew by 9.9 percent in the year to June 2017 compared to 23.8 percent in the year to June 2016.

The profitability of CIs improved as they recorded overall profits of USh.270.1 million in the year to June 2017, an improvement from losses of USh.1.2 billion in the year to June 2016. The resultant ROA and ROE ratios stood at 0.1 percent and 0.3 percent respectively, in comparison to -0.3 percent and -1.7 percent in the year to June 2016. Asset quality improved in the year to June 2017 as indicated by a decline in the NPL ratio from 5.3 percent to 4.0 percent during the period under review.

Microfinance deposit-taking institutions

The MDIs were adequately capitalised as at June 2017. The overall core capital adequacy ratios increased from 35.9 percent at June 2016 to 38.9 percent at June 2017; while the total capital adequacy ratio increased from 39.1 percent at June 2016 to 42.3 percent at June 2017.

Similar to the CIs, MDIs registered increased growth at a significantly subdued rate. Asset growth declined from 22.6 percent in the year to June 2016 to 6.4 percent in the year to June 2017. This was attributed to a contraction in credit growth, from 24.3 percent recorded in the year to June 2016 to -4.1 percent in the year to June 2017. Indicators showed that liquidity for MDIs improved as liquid assets to total deposits increased from 51.9 percent at June 2016 to 66.3 percent at June 2017. However, deposit growth was subdued to 1.2 percent in the year to June 2017, down from 24.9 percent in the year to June 2016.

The profitability of MDIs declined as they recorded overall profits of about USh.6.6 billion in the year to June 2017, a decline of 8.3 percent from profits in the year to June 2016. The ROA and ROE ratios stood at 2.8 percent and 8.8 percent respectively, in comparison to 3.3 percent and 10.5 percent in the year to June 2016. Asset quality deteriorated in the year to June 2017 as indicated by an increase in the aggregate NPL ratio from 3.5 percent at June 2016 to 5.0 percent at June 2017, a 5-year high. All MDIs reported 5-year high NPL ratios at June 2017. On a historical basis, therefore, credit risk in MDIs is relatively high and is a concern going forward.

2.9. Conclusion

At the end of June 2017, banks' indicators of financial soundness remained strong. Both the banking industry's core and total regulatory capital increased as a percentage of risk-weighted assets to provide a firm buffer against solvency risk. The banking industry also experienced improved funding and liquidity conditions due to increased deposit growth and holdings of high quality liquid assets. Credit risk still remains a threat to the recovery in credit growth. However, as domestic economic conditions improve, supported by expansionary monetary policy, it is expected that growing aggregate demand will be matched by increased credit supply.

In terms of profitability, the performance of the banking industry was mainly affected by reduced asset quality that began in 2016 and resulted in a significant amount of loan write-offs in the quarter to March 2017. Hence, the rebound in profitability for banks predominantly hinges on an improvement in the quality of the loan books. Banks are also likely to be faced with sharp adjustments in net interest margins if any further decreases in short-term interest rates occur without a significant increase in lending activity.

3. Financial Infrastructure Oversight and Other Financial Corporations

This chapter highlights the developments and the performance of payment systems in Uganda. Financial infrastructures, including payment systems, is crucial for intermediation in the financial system, financial inclusion, monetary policy and consequently, economic growth. Hence, it is important to analyse their performance. Furthermore, Uganda's financial system is linked into the global payments infrastructure and financial system, through correspondent relationships. However, recently some global banks have been severing their correspondent banking relationships, affecting a number of countries across the world. These developments and their implications for Uganda's financial system are also reviewed in this chapter.

3.1. Performance of payments systems

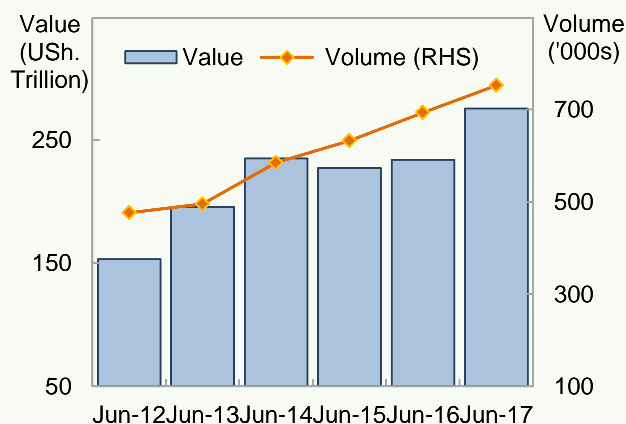
As at the end of June 2017, Uganda's payment systems infrastructure included: the Uganda National Interbank Settlement System (UNISS) – Uganda's Real Time Gross Settlement system for large value funds transfer; the Electronic Clearing System (ECS) – for cheques, direct debit and credit transfers; and an electronic Central Securities Depository (CSD) – for government securities. Private sector players also provide a number of payment systems and instruments, including mobile money, cross-border money remittance and internet banking services.

3.1.1. Uganda National Interbank Settlement System (UNISS)

The UNISS, Uganda's Real-Time Gross Settlement (RTGS) system, is a systemically important payment system (SIPS). Systemically important payment systems are defined as a large-value and retail payment systems which, owing to their transaction volume, market share, cross-border relevance and the provision of services to other infrastructures, are deemed significant for financial stability. By this definition, UNISS is a SIPS because it processes time-critical, high value payments among banks, facilitates settlement of netted positions from other multilateral settlement systems and connects to similar RTGS systems in East Africa. Direct access to UNISS is currently being done by only commercial banks, and these banks act as intermediaries for other financial institutions and markets. However, tier 2 and tier 3 financial institutions can also directly access the UNISS if they meet the necessary requirements, but none of these institutions is currently a direct participant.

The UNISS operations encountered two major disruptions during the year to June 2017, leading to unavailability of the system beyond the acceptable two hours. These disruptions did not affect the system's safety and efficiency as all the payments for the day were settled by close of day. The volumes and value of transactions denominated in Uganda shillings through UNISS continued to increase in the year to June 2017. The volume of transactions rose by 9.7 percent from 693,664 to 752,475 in the year to June 2017, while the value of these transactions increased by 17.1 percent from USh.234.0 trillion to USh.275.4 trillion.

Chart 36: UNISS transactions by volume and value



Source: Bank of Uganda

The UNISS also settles transactions in select foreign currencies, namely: United States Dollar (USD), European Union Euros (EUR), the Great British Pound (GBP), Kenyan Shilling (KES), Tanzanian Shilling (TZS) and Rwandan Franc (RWF). Transactions in dollars registered the highest activity in terms of both value and volumes settled in the year ending June 2017, with USD7.2 billion settled in 118,332 transactions. The Kenyan shilling recorded the second highest volume and value of transactions with an equivalent of USD375.8 million settled in 5,898 transactions. Details are shown in Table 13 below.

Table 13: UNISS transactions in foreign currencies

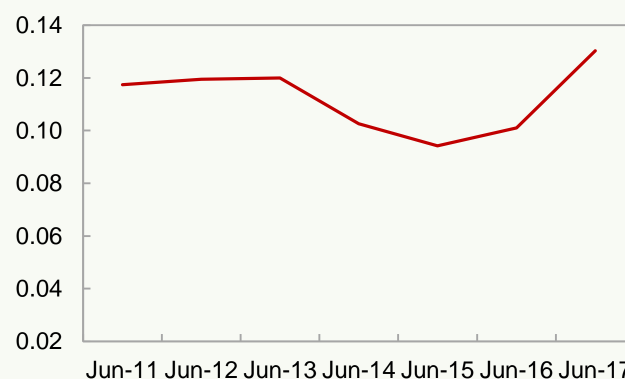
Year Ended	Jun-15	Jun-16	Jun-17
Total value settled in all foreign currencies (USD equivalent; millions)	**8,260**	**7,724**	**7,958**
Proportion by currency : Value (%)			
USD	93.5	90.6	90.6
EUR	2.4	4.1	3.4
GBP	0.4	0.6	1.1
KES	3.6	4.6	4.7
TZS	0.0	0.1	0.1
RWF	0.0	0.0	0.2
Total volume settled in all foreign currencies	**102,381**	**118,177**	**127,594**
Proportion by currency : Volume (%)			
USD	94.2	93.4	92.7
EUR	1.9	1.9	1.8
GBP	0.7	0.6	0.7
KES	3.0	4.0	4.6
TZS	0.1	0.2	0.2
RWF	0.0	0.0	0.0

Source: Bank of Uganda

Concentration of payments in UNISS

During the year ended June 2017, the total volume of transactions settled in UNISS, in Ugandan shilling and foreign currency, was 867,492. Analysis of payments concentration indicates that four banks accounted for 60.4 percent of the total payments value. In terms of the number of transactions, concentration was much lower; six banks received and submitted 52.1 percent of all payments. The aggregate HHI, in respect to the value of payments among the 26 banks, was 0.124 in June 2017, up from 0.101 in June 2016 (Chart 37). The steep rise in HHI which began June 2015 signals increasing concentration in the UNISS payment system.

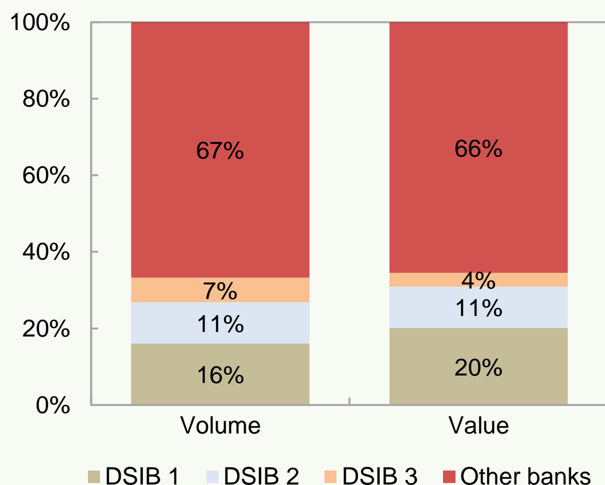
Chart 37: Herfindahl–Hirschman Index for UNISS transaction values



Source: Bank of Uganda

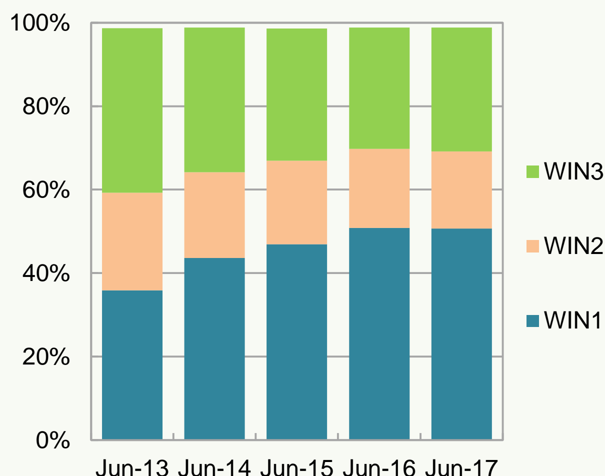
Furthermore, UNISS transactions were highly concentrated among the three domestic systemically important banks (D-SIBs), which accounted for 33.0 percent of the total transaction volume and 34.0 percent of the total transaction value, in both Uganda shilling and foreign currency, as illustrated in Chart 38 below.

Chart 38: DSIBs' activity on UNISS for the year ended June 2017 (percent)



Source: Bank of Uganda

Chart 39: UNISS transaction volumes by settlement window (WIN), (percent)



Source: Bank of Uganda

UNISS settlement windows

UNISS' settlement schedule runs from 08.30hrs to 16.30hrs, but operates in three settlement windows, with transaction charges varying over the settlement windows. Transactions within window 1 (08.30hrs – 13.00hrs) are charged a discounted fee of USh.500; Window 2 (13.00hrs – 15.00hrs) transactions are charged the standard fee of USh.1,000; while transactions in Window 3 (15.00hrs – 16.30hrs) are surcharged USh.1,500. The chart below shows that, over time, more payment instructions were settled within the first window. The rationale behind this incentivised pricing structure is to induce UNISS participants to process their payment instructions earlier in the day, in order to minimise potential liquidity and settlement risks that the participants might otherwise face if most were to defer their payments towards the end of the settlement schedule. Therefore, this allows for the optimal use of liquidity, thus avoiding a gridlock situation as all payments are settled in real time regardless of the settlement window.

3.1.2. East African Payment System (EAPS)

The East African Payment System (EAPS) is a multicurrency system, which connects the RTGS systems of the East African Community (EAC) member countries, namely: Kenya, Rwanda, Tanzania and Uganda.

There were no significant disruptions or downtime to EAPS during the year ended June 2017. The volumes and values of transactions continued to register significant growth during the year to June 2017, as compared to the previous year, while the value of the transactions dropped. Table 14 shows that in terms of value, the majority of EAPS transactions continue to be made in Kenya shillings with 82.4 percent for inward transactions and 84.9 percent for outward transactions. The Tanzania shilling was the least transacted in terms of volume and value in the period under review.

3.1.3. COMESA Regional Payment and Settlement System

REPSS is a cross-border clearing system for transfer of funds within the Common Market for Eastern and Southern Africa (COMESA), in both United States Dollars and Euros. In the year to June 2017, there were 124 transactions made in United States Dollars, equivalent to a total of USD6.2 million, and only two transactions in the Euro totalling EUR1,137.5.

Table 14: EAPS transactions by volume and value

Year ended	Jun-15		Jun-16		Jun-17	
	IN	OUT	IN	OUT	IN	OUT
Total value settled (USh. equivalent; billion)	**317.7**	**193.5**	**625.4**	**678.6**	**548.8**	**690.8**
Proportion by currency: Value (%)						
UGX	10.1	14.9	16.9	14.1	11.2	9.1
KES	89.8	85.0	82.0	84.8	82.4	84.9
TZS	0.1	0.1	1.0	1.0	2.0	1.6
RWF	0.0	0.0	0.1	0.1	4.4	4.5
Total volume settled	**1,585**	**2,944**	**2,571**	**4,853**	**4,359**	**5,487**
Proportion by currency: Volume (%)						
UGX	69.2	50.8	56.2	30.2	69.1	21.4
KES	29.7	47.0	41.7	67.0	29.0	75.5
TZS	1.0	2.2	1.8	2.7	1.2	2.6
RWF	0.1	0.0	0.2	0.1	0.6	0.5

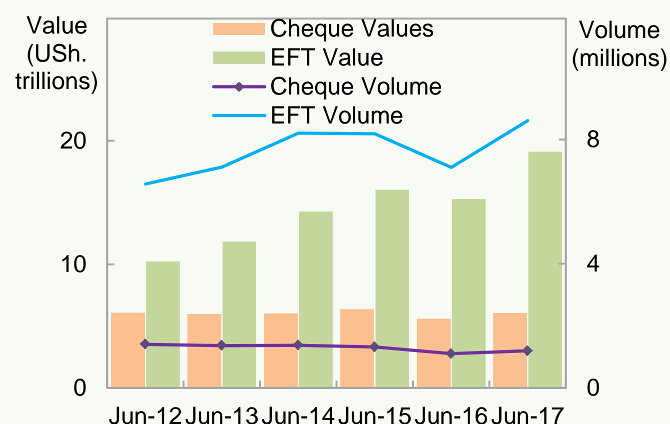
Source: Bank of Uganda

3.1.4. Electronic Clearing System (ECS)

The Electronic Clearing System (ECS) automates the process of clearing cheques and electronic funds transfer (EFT) transactions, both in Uganda shillings and the widely used foreign currencies, namely: USD, EUR, GBP and KES.

In the year ending June 2017, 1.2 million cheque transactions valued at USh.6.1 trillion were cleared in the ECS. This is in comparison to the 1.1 million cheque transactions with a total value of USh.6.0 trillion that was cleared through the ECS during the previous year. Furthermore, the total volume of EFTs (credits and debits) transactions increased significantly by 21.1 percent to 8.6 million in the year ending June 2017, as compared to the 7.1 million transactions recorded in the year ending June 2016. The value of these transactions increased by 25.1 percent over the same period, from USh.15.3 trillion to USh.19.1 trillion.

Chart 40: ECS transaction values and volumes



Source: Bank of Uganda

Transactions in foreign currencies continued to grow as shown in Table 15 below. The ECS cleared a total volume of 77,718 cheques and 72,384 EFTs in the year to June 2017 in the main foreign currencies – USD, EUR, GBP and KES. The transactions made in US dollars registered the highest activity with 70,792 cheques equivalent to USD271.7 million and 74,715 EFT transactions valued at USD829.2 million.

Table 15: ECS activity in foreign currency

Year ended	Jun-16		Jun-17	
	EFT	Cheques	EFT	Cheques
Total value cleared (USD equivalent; millions)	**649.5**	**248.9**	**866.3**	**272.9**
Proportion by currency: Value (%)				
USD	94.5	99.7	95.7	99.6
EUR	5.2	0.2	3.8	0.3
GBP	0.2	0.1	0.4	0.1
KES	0.0	0.0	0.0	0.0
Total volume cleared	**53,831**	**71,578**	**72,384**	**77,718**
Proportion by currency: Volume (%)				
USD	98.3	99.5	97.8	99.4
EUR	1.3	0.3	1.8	0.4
GBP	0.4	0.2	0.4	0.2
KES	0.0	0.0	0.0	0.0

Source: Bank of Uganda

3.1.5. Mobile money payment systems

Mobile money operations continued to grow in the year ended June 2017, with increases in transaction volumes and values, and registered customers, as shown in Table 16.

Currently, there are four mobile network operators (MNOs) providing mobile money services: MTN Uganda through MTN Mobile Money, Airtel Uganda through Airtel Money, Africell Uganda through Africell Money Uganda, and Uganda Telecom through M-Sente. However, there are also non-MNO mobile payments providers, such as M-Cash, Ezee Money, and Micro-pay. The industry remains dominated by two players. Indeed, the Herfindahl-Hirschman Index (HHI), a common measure of market concentration, stood at 0.5 in June 2017, a decline in concentration from 0.8 in June 2013.

Table 16: Performance of mobile money payment systems

Year ended	Jun-16	Jun-17	Change (%)
Number of transactions (millions)	809.1	1,111.0	37.3
Value of transactions (USh. trillions)	37.4	52.8	41.0
Number of registered customers (millions)	19.6	22.9	16.6
Number of agents	119,581	147,146	23.1

Source: Bank of Uganda

The concentration of mobile money transactions among two players is largely attributed to their greater customer base, compounded by the closed nature of the MNOs' mobile money operations that influence customers to remain on a network to which most of their transacting counterparties also subscribe to (network effects). Concentration increases the systemic importance, and therefore risk, attributed to dominant players. Hence, promoting inter-operability among mobile money providers can minimise the concentration by overcoming the network effects challenge. Although inter-operability fosters efficiency and accordingly promotes financial inclusion, it may magnify the systemic risks posed by dominant service providers

through contagion, thus posing a threat to financial stability.

3.1.6. Interswitch, bank branches and automated teller machines

Interswitch

Interswitch Uganda provides transaction-switching and electronic payments processing services, through connected automated teller machines (ATMs) of subscribing financial institutions, and select mobile money platforms. This enables the financial institutions' customers to access their bank and/or mobile money accounts using any ATM of any of the financial institutions on the Interswitch network.

By end of June 2017, 15 financial institutions (11 commercial banks, 3 credit institutions, and 1 microfinance deposit-taking institution) were connected to Interswitch and sharing their network of 409 ATMs. In the year to June 2017, a total of USh.217.6 billion was transacted using the Interswitch platform, representing a 29.8 percent increase, relative to the USh.167.7 billion transacted in the year to June 2016. The growth in Interswitch activity indicates an increase in sharing of ATM infrastructure among the banks, further easing access to financial services.

Table 17: Interswitch activity

Year ended	Jun-16	Jun-17	Change (%)
Transaction value (USh. Billions)	167.7	217.6	29.8
Transaction volume (Millions)	2.2	2.7	23.2
ATMs on Interswitch	320	409	15.1

Source: Bank of Uganda

Bank branches and automated teller machines

As at end of June 2017, the banking sector registered a decline in branch network and number of ATMs, mainly on account of the transfer of the assets and liabilities of Crane Bank Limited (now defunct) to DFCU Bank Limited. In addition, other banks are rationalising their branch and ATM operations, shifting to the more efficient alternative channels such as mobile banking, in order minimise operational costs. As at end-June 2017, the total number of bank branches stood at 546 compared to 566 branches at the end of June 2016. Similarly, the number of ATMs decreased from 862 to 818 in the same period (see Table 18).

Table 18: Number of commercial bank branches and ATMs

Year ended	Jun-16	Jun-17
Commercial banks	25	24
Commercial bank branches	566	546
ATMs	860	818

Source: Bank of Uganda

Box 3: De-risking in the global financial system and its implications for Uganda

A. Introduction

In the global financial system, traditional correspondent banks are increasingly becoming averse to smaller respondent banks, consequently isolating them – a process termed as ***de-risking***.

The Financial Action Task Force on Money Laundering (FATF) defines de-risking as a situation where financial institutions terminate or restrict business (correspondent banking) relationships with entire countries or classes of customers in order to avoid, rather than manage, risks in line with the FATF's risk-based approach. Correspondent banking can be defined as an arrangement where one bank (the "correspondent") provides a current or other liability account, and related services, to another bank (the "respondent"), used for the execution of third-party payments and trade finance, as well as its own cash clearing, liquidity management and short-term borrowing or investment needs . Therefore, correspondent banking is an integral component of the global financial system.

Crucially, by breaking correspondent banking relationships, de-risking threatens cross-border transactions and constrains access to financial services in different jurisdictions, consequently undermining international trade and cross-border financial transactions. Moreover, de-risking threatens to push users of the formal regulated and supervised payments channels towards the alternative channels that may be riskier and harder to regulate and supervise, such as virtual currencies.

B. De-risking in Uganda's banking sector

Uganda and other countries in East Africa have been affected by de-risking, though at different scales. During the 20th ordinary meeting of the Monetary Affairs Committee (MAC) of the East African Community (EAC) held on July 14, 2016, the Governors of the partner states' central banks observed heightening risk of isolation of the region's financial system from the global financial system. Consequently, the Governors directed central banks to assess the situation, with objective of developing appropriate mitigation measures. Bank of Uganda (BOU) undertook an assessment to ascertain whether Uganda's financial sector had been affected.

BOU established that in the recent past, three commercial banks had been affected by correspondent banks terminating their correspondent banking relationships. However, this had not materially impacted the banks involved, nor affected Uganda's financial system. Similarly, the banking sectors in Kenya, Burundi, Rwanda and Tanzania had also been victims of de-risking, with some countries having a significant number of their banks affected. Generally, the reasons for the de-risking included: concerns about inadequate customer due diligence and risk assessment by respondent banks, posing risks of money laundering and financing of terrorism (ML/FT); heightened regulatory burden on the correspondent banks, related to anti-money laundering and counter financing of terrorism (AML/CFT) or the uncertainties related to the implementation of these requirements and the potential reputational risk in case of non-compliance; and unprofitable correspondent banking relationships, largely due to insufficient volume of transactions.

Analysis conducted by different bodies, including the FATF and the Committee on Payments and Market Infrastructure (CPMI), confirms the aforementioned reasons. The analysis found that correspondent banks

were de-risking due to AML/CFT concerns, including inadequate risk assessment of customers, associated with the respondent banks' business and/or jurisdiction. This was often compounded in cases where the respondent bank was located in a jurisdiction that was perceived to be too risky. Furthermore, the banks cited costs associated with implementing conflicting regulatory requirements, and consequent penalties imposed by their home supervisors and law enforcement, with potential reputational and liability risks, as another reason for de-risking. In other cases, correspondent banks were severing relationships that were not sufficiently profitable, due to insufficient volumes, with the banks unable to recover their compliance costs.

C. Policy action

Undoubtedly, concerns about financial integrity, especially the risk of money laundering and terrorism financing, are the main reasons for de-risking by correspondent banks. However, Uganda has, over time strengthened the legal and regulatory framework, to avert money laundering and terrorism financing. Specifically, the Anti-Terrorism (Amendment) Act (2017), the Anti-money Laundering Act (2013), the Anti-Terrorism Act (2001), and the Financial Institutions (Amendment) Act (2016) have been enacted, along with other complimentary laws. Furthermore, the Financial Intelligence Authority was also set up as part of the regulatory framework, to oversee and ensure financial integrity.

Other financial sector regulators are also mandated to ensure that financial institutions comply with AML/CFT requirements. In this regard, BOU continues to strengthen its supervisory framework in order to ensure that supervised financial institutions comply with the AML/CFT legal and regulatory framework, and international standards/requirements. In addition, BOU is enhancing cooperation with other regulatory authorities in Uganda, and in other jurisdictions, through memoranda of understanding (MOUs). Furthermore, BOU continues to refer to, and considerately enforce, standards, guidance and requirements by international institutions, especially the United Nations, FATF, CPMI, and the Basel Committee on Bank Supervision, among other authorities.

D. Conclusion

Correspondent banking relationships are undoubtedly an indispensable link between Uganda's financial system and the global financial system. It is therefore imperative that financial institutions avoid being de-risked. With ML/FT concerns at the forefront of de-risking, financial institutions need to proactively improve AML/CFT frameworks; by enhancing risk management and ensuring compliance with the essential AML/CFT legal regimes and other international standards, guidance or requirements.

3.2. The capital markets

In the year ended June 2017, activity in the domestic equities market was dominated by foreign institutional investors who accounted for over 80.0 percent of the turnover at the Uganda Securities Exchange (USE). Foreign institutional investors exhibited a tendency of "buying to hold" which has gradually led to a liquidity mop-up within the equities as stocks continue to move from the hands of local retail investors to the foreign investors.

The market did not witness any new listings during the review period. All currently listed equities on the USE include eight local companies and eight cross-listed companies from the Nairobi Securities Exchange (NSE). Of the eight locally listed

companies, four are financial sector firms (three commercial banks and one insurance firm), whereas the rest operate in the energy and the services sectors. On the other hand, of the eight cross-listed companies, three operate in the financial services sectors (two banks that have expanded their operations in Uganda), and the rest operate within the services sector of the East African Region.

Despite the lack of new listings, Uganda's second securities exchange, ALTX East Africa Limited, was launched in July 2016. The exchange is not operating at full capacity with minimal activity and few members. The bourse is yet to operationalise its pan-African dream, which targets providing a trading platform for companies across the continents.

In a bid to strengthen reforms and provide strategic direction to capital markets in Uganda, the Capital Markets Authority (CMA) launched a 10-year transformative master plan in June 2017. This development plan aims to position capital markets in Uganda to meet the long-term funding needs of public and private sector by: increasing access to alternative funding in order to reduce pressure on bank financing, particularly for the private sector; increasing the size of domestic savings; and lastly, improving the efficiency and effectiveness of regulation and stock exchange operations.

3.2.1. Performance of equity market

Equity turnover at the USE dipped by 42.5 percent in the year to June 2017, from USh.204.3 billion to USh.117.5 billion. Average turnover per trading session also trended downwards from USh.0.8 billion to USh.0.4 billion in the same period. The total volume of shares traded receded by 9.7 percent, from 1,230.7 million in the previous financial year to 1,111.1 million. Domestic market capitalization was USh.4.3 trillion as at the end of June 2017, a drop of 6.0 percent from USh.4.5 trillion. The USE Local Counter Index dipped by 6.0 percent, closing the year at 367.4 index points from 390.2 index points. This was mainly due to a decline in the prices of most listed domestic counters.

Table 19: Performance of equity market

	Jun-16	Jun-17	Change (%)
Equity turnover (USh. billion)	204.3	117.5	-42.5
Average turnover per session (USh. billion)	0.8	0.4	-46
Share volume	1,230.7	1,111.1	-9.7
Domestic market capitalization (USh. trillion)	4.5	4.3	-5.1
USE Local Counter Index (Points)	390.2	367.4	-6.0

Source: Capital Markets Authority

3.2.2. Primary and secondary market activity

The USE did not report any primary market activity in the year ended June 2017. However, during this period, CIC General Insurance Uganda received approval from CMA for a public offer for the sale of 724,900 ordinary shares at USh.10,000 each to Uganda Co-operative Savings and Credit union through a public offer of shares. This was aimed at raising capital as well as increasing the stake held by the Uganda Co-operative Savings and Credit Union that currently holds a 0.7 percent ownership in the CIC Africa (Uganda) Limited.

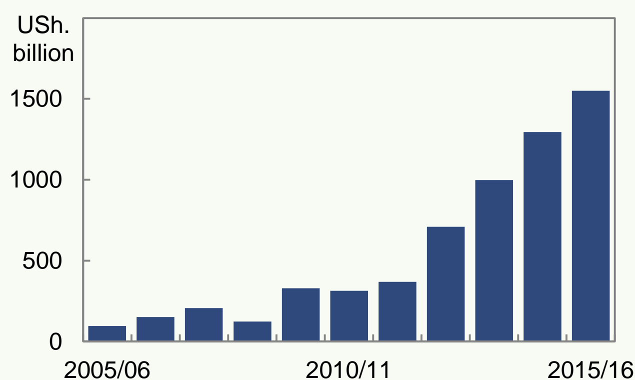
In secondary market activity, private equity firm Actis, through its special purpose vehicle Umeme Holdings Limited, exited the Umeme counter by selling down 232 million shares. The sale of the 14.3 percent stake in the company marked the full exit of Actis from Umeme and raised a total of USh.113.2 billion.

3.2.3. Fund management

The total funds under management by fund managers licensed by CMA stood at USh.1.6 trillion as at the end of June 2016. This was an increase of

20.0 percent from USh.1.3 trillion at the end of June 2015. The increase was as a result of the appreciation in value of underlying assets, as well as increased membership in schemes whose funds are under management.

Chart 41: Funds under management (USh. billion)



Source: Capital Markets Authority

3.2.4. Risks to capital markets

One of the most pertinent risks to the operations of the capital markets revolves around anti-money laundering and terrorism financing. In an effort to curb this risk, the CMA requires fund managers to undertake enhanced due diligence to confirm beneficial ownership for all new clients signed so as to combat the risk of money laundering at entry Level. In addition, they are also required to institute adequate AML/CFT controls in the areas of corporate governance, record-keeping and staff training.

In regard to interest rate risk, adverse market movements affect portfolio performance and consequently the revenue generated by fund managers, which is based on the assets under management (AUM). In order to ensure that fund managers have sufficient capital to absorb any losses, these fund managers are required to hold a minimum of USh.50 million in paid-up share capital and reserves at any time during the license period. In addition, the paid-up share capital must always be unimpaired and cannot be advanced to the directors or associates of the fund manager.

Capital market operations are further hindered by the narrow distribution channels which have affected the market share of fund managers as well as capacity of human resources, both from the market side and from the supervisory side.

3.3. The retirement benefits sector[13]

Assets in the retirement benefits sector increased by 16.9 percent, from USh.6.5 trillion in 2015 to USh.7.6.trillion in 2016. This growth was due to contributions and investment earnings. However, in an environment of declining interest rates and depressed equity market conditions, investment income dropped from USh.908 billion in 2015 to USh.760 billion in 2016. This decline was attributed to several factors including: marking to market of the trading portfolio of listed equities; exchange rate movements, declining interest rates; and credit duration, all of which affected the value of investments and earnings. The rate of return on the sector's total investment portfolio decreased to from 18.2 percent in 2015 to 12.0 percent in 2016. When compared to an average inflation rate of 5.5 percent over the same period, it implies a real rate of return of 6.5 percent.

Table 20: Investment portfolio of the retirement benefits sector

Investment type	2015	2016
Total investments (billions)	**6,375.6**	**7,480.7**
Composition	**%**	**%**
Government bonds & treasury bills	65.9	68.7
Corporate bonds	2.4	2.0
Term fixed deposits	5.6	4.2
Real estate	7.0	6.9
Quoted equities	16.8	16.4
Private equity	1.2	0.0
Offshore investments	0.0	0.0
Guaranteed funds	0.3	0.3
Others investments *	0.8	1.5

[13] Latest available data is up to December 2016.

** Other investments include loans to members and associates*

Source: URBRA

National Social Security Fund (NSSF)

In 2016, the NSSF assets grew at a rate of 18.0 percent, which was driven by growth in the contributions, surcharges and investment earnings. The entity held over USh.6.5 trillion by the end of June 2016, accounting for 86.0 percent of total assets in the retirement benefits sector. Furthermore, the Fund earned USh.671.0 billion on its investment portfolio in 2016 compared to USh.802.0 billion in 2015 and subsequently experienced a loss of USh.82.2 billion (12 percent of investment income) resulting from marking to market of the trading portfolio of listed equities. However, the bulk of the equity investments were made with a long-term focus and so, short-term fluctuations in prices did not affect profits on a net basis.

3.3.1. Risks to the retirement benefits sector

The Uganda Retirement Benefits Regulatory Authority (URBRA) Act 2011 requires licensed providers to adhere to prescribed asset allocation for proper diversification of scheme fund investments. This serves to limit the impact both endogenous and exogenous risks to the sector.

In 2016, URBRA introduced a risk-based supervision (RBS) approach to supervision (offsite analysis and on-site inspections) to better identify potential risks faced by schemes, and mechanisms to mitigate those risks. The introduction of RBS also enables resources to be directed to entities that appear to pose the greatest risk or threat. In line with its implementation, an off-site analysis of 39 occupational schemes in the year revealed that 30 schemes currently pose moderate risk to the sector. The analysis also showed that NSSF's performance and risk indicators were deteriorating. URBRA continues to monitor all schemes to bring the risk level in the sector to a minimum.

Going forward, URBRA will continue to identify ways to address the other challenges that affect the sector such as poor governance, fraud, technical incompetence of trustees and key officers, inefficient administrative systems, poor quality of data and inadequate proficiency of fund managers.

3.4. The insurance sector

The insurance industry registered a 15.6 percent growth in gross written premium income in the year to June 2017, from USh.310.3 billion to USh.358.5 billion. On the other hand, net incurred claims rose by 4.4 percent during the same period, from USh.75.2 billion to USh.78.4 billion. Reinsurance premium ceded for amounted to USh.133.1 billion as at end June 2017 which was an increase from USh.114.1 billion recorded in June 2016. The industry's net earned premium in the year ended June 2017 was USh.209 billion, up by 12.6 percent from USh.185.7 billion in the previous year.

The industry's investment assets grew by 26.3 percent from USh.213.0 billion in the previous year to USh.269 billion in June 2017. This reflected availability of very attractive investment opportunities in the domestic markets. The sector's profitability was boosted by a reduction in the loss ratio[14] from 40.5 percent in June 2016 to 37.6 percent in June 2017.

In regard to risks to the sector, there are emerging risks that pose a serious threat to the insurance sector yet the industry may not have moved as fast in addressing these risks. Such risks include fraud risk and cyber risk. Also, out of the 29 insurance

[14] The loss ratio is the ratio of total losses incurred (paid and reserved) in claims plus adjustment expenses divided by the total premiums earned.

companies[15], only 4 companies are locally owned while 25 companies are foreign-owned. Most of the companies operate under a group structure/conglomerate; therefore, it is pertinent to closely monitor the events and activities of such groups so as to ensure that the effects of such activities do not spill over to other sectors and affect financial stability.

3.4.1. Sector developments

In the year to June 2017, the insurance regulations on bancassurance were finalised, allowing for the use of financial institutions such as commercial banks as a distribution channel for insurance products and services. Due to the wide bank branch network, it is expected that this distribution channel will improve access to insurance. In addition, the insurance industry has developed a mobile payment platform which will enable vehicle owners to purchase motor third party insurance through mobile phones. The payment platform will enhance access to insurance.

3.5. Interconnectedness in the financial sector

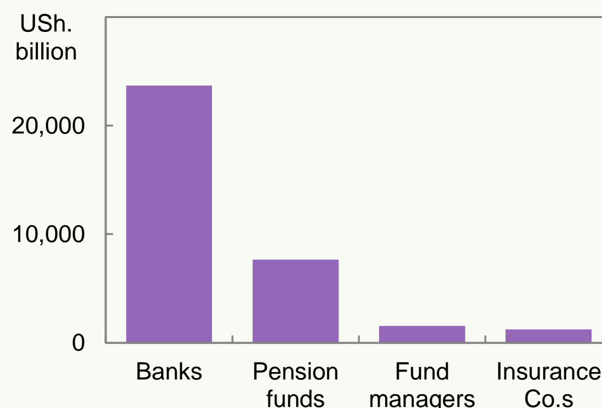
Common exposures of financial market segments could enhance the impact of systemic shocks. Commercial banks are the main domestic financial counterparties for most segments of Uganda's financial sector.

In regard to the capital markets, approximately 81.0 percent of assets under management (AUM) by fund managers are concentrated within the financial sector. The Capital Markets Authority however is working on changing the AUM reporting format to enhance the monitoring of asset concentration. The Authority is also planning the introduction of risk-based capital adequacy requirements for fund managers to match the level of risk against the level of business undertaken by the manager.

The retirement benefits sector is also heavily exposed to the banking sector. However, due to the deliberate diversification provided for under the investment regulations, the impact of any spill-over effect resulting from a shock to the banking sector would be minimal.

Similarly, the insurance sector is closely interwoven with the banking sector especially through their investments in fixed deposits. The sector is also heavily exposed to the real estate sector through their property investments. In an effort to build resilience to shocks to the sector, insurance players are more vigilant on the risks they underwrite and on the risk mitigation strategies they put in place.

Chart 42: Total assets for Ugandan financial institutions as at December 2016



Source: BOU, CMA, IRA, URBRA

However, these segments of the financial sector are interconnected through mutual exposures in the form of deposits, loans, ownership interests and other instruments. Therefore, a shock to the financial sector could intensify systemic risk and the spread of financial distress across the different components of the financial sector. It is therefore imperative to

[15] As at end June 2017, IRA had licensed 20 non-life insurance companies, 9 life insurance companies, 6 health management organisations, 35 insurance brokers, one reinsurance broker; 22 loss assessors/adjusters and 1,396 insurance agents.

continue to monitor the level of interconnectedness within the financial sector alongside the performance of each sector.

4. The Outlook for Financial Stability

The outlook for financial stability is based on the risks faced by the banking system and the system's resilience in the face of those risks. Overall, risks to systemic stability remained high in the year to June 2017, but started to reduce in the second half of the year. Stress tests results show that the sector has adequate capital buffers to withstand these shocks going forward.

4.1. Summary of risks facing the banking sector

a) Risks from the macroeconomy

The slowdown in the domestic economy during last year continued to weigh on the performance of the banking system in the year to June 2017. GDP expanded by 4 percent in FY 2016/17 in real terms, lower than 4.8 percent in 2015/2016. This in part reflected the slow-down in aggregate demand and other macro challenges. These macro financial risks affected were reflected in the rise in NPLs of households and corporations.

However, global financial conditions have improved over the year, while indicators show that the domestic economic activity is starting to pick up.

b) Credit risk

During 2016/2017, the asset quality of banks remained a key concern for systemic stability. The ratio of non-performing loans to total loans increased from 8.3 percent at June 2016, peaked at 10.5 percent in December 2016 before reducing to 6.5 percent at June 2017.

NPLs appear to have reached a plateau and loan performance is likely to improve over the next year, boosted by rising economic prospects. Nevertheless, there are two main downside risks to this outlook. First, almost half of the banks still have NPL ratios above the average of 6.5 percent in June 2017. Secondly, the volume of watch loans remains historically high (see Chart 30). This raises concerns about the potential consequences on bank capital as banks take steps to clean their loan book.

Another major challenge facing banks is the slow growth of loans, which rose by only 0.9 percent between June 2016 and June 2017, far lower than 3.7 percent growth recorded in the previous year. In particular, banks constricted credit to the real estate sector, reflecting the elevated risks from the slowdown in residential property prices. The risk to banks is that slow loan growth may affect bank profitability and income going forward, given that interest income from lending accounted for 50 percent of banks gross income at June 2017. Bank of Uganda reduced the Central Bank Rate (CBR) to 10.0 percent in June 2017, which is expected to contribute to better loan performance.

4.2. Stress test results for the banking sector

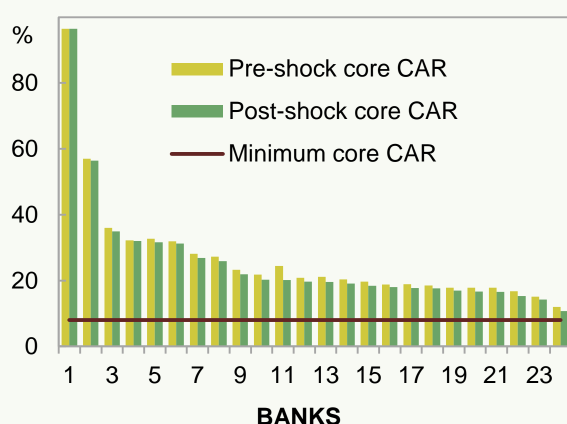
Bank of Uganda carries out quarterly stress tests to assess the resilience of the banking sector to plausible systemic risks. The stress tests for June 2017 focused on the two main potential sources of vulnerabilities for the Ugandan banking sector; credit and liquidity risks.

Credit risk

Credit shocks were conducted to assess the effect a further deterioration in asset quality would have on banks' capital for the next year. The ratio of non-performing loans to total loans is taken as the main measure of credit risk.

The first credit risk test tests the resilience of banks to the increase in the industry's average NPL ratio to its highest level in the 10 years to June 2017, which was 10.5 percent for the quarter ending December 2016. The test assumes constant credit growth, no change in core capital for the projection period, and 20 percent provisioning on new non-performing loans. The results show that all banks have adequate capital buffers to absorb this deterioration in loan quality.

Chart 43: Stress test results of shock to banks' aggregate credit



Source: Bank of Uganda

Liquidity risk

Although indicators show that overall liquidity risk for banks remained stable in the year to June 2017, concerns remain about the potential risks from a reversal of callable funds and whether some banks have adequate liquid assets to fund their short to medium-term funding activities in a period of stressed liquidity.

The stress test for liquidity risk simulated a bank run to determine the impact of a sudden withdrawal of customer deposits. The resilience of banks to liquidity risk is judged by their ability to withstand a liquidity drain without resorting to external liquidity support in a 7-day period. This test does not consider assumptions about rollovers, increases in borrowings and maturity extensions.

The results revealed that liquid assets of six banks would be depleted over a 7-day period of distress, assuming a daily withdrawal rate of 5 percent for demand and savings deposits and 3 percent for term deposits. Compared to June 2016, the results suggest that as at the end of June 2017, banks were more resilient to liquidity risk since the bank run test resulted in fewer bank failures with a similar reduction in deposits.

Table 21: Summary of stress test results for liquidity risk

	Key indicators	Day 3	Day 5	Day 7
June 2015	Liquid assets to total deposits (%)	38.6	32.8	26.5
	Reduction in total deposits (%)	12.7	20.2	27.1
	No. of banks failing tests	2	5	9
June 2016	Liquid assets to total deposits (%)	35.1	29.0	22.3
	Reduction in total deposits (%)	12.7	20.3	27.1
	No. of banks failing tests	5	9	11
June 2017	Liquid assets to total deposits (%)	42.8	37.3	31.3
	Reduction in total deposits (%)	12.9	20.5	27.4
	No. of banks failing tests	1	3	6

Source: Bank of Uganda

4.3. Looking ahead: prospects for financial stability

During 2016/2017, the upside risks highlighted in our last *Report* largely materialised, manifested in challenging conditions for the banking industry. The key vulnerabilities related to lower than expected economic growth, slow loan growth and elevated levels of credit risk which had a significant impact on bank profitability.

Looking ahead to 2017/18, bank performance is expected to start to improve, as economic growth picks up and banks clear the legacy of bad loans. The stress tests show that banks have adequate

capital and liquidity buffers to withstand plausible shocks.

5. Exploring The Factors Affecting The Performance Of Bank Credit To Uganda's Real Estate Sector

The real estate sector accounts for the largest share of bank loans. This Chapter sets out the results of a survey on the real estate sector undertaken by Bank of Uganda as well as the policy implications.

5.1. Introduction

The growing exposure of the Ugandan banking system to the real estate sector, both by in terms of credit extended to the sector and collateral held for other loans, has implications for banks' performance. It therefore important to explore the drivers of credit quality within the real estate sector in order to develop efficient measures to protect the banking system from any spill-over effects arising from failures in the sector.

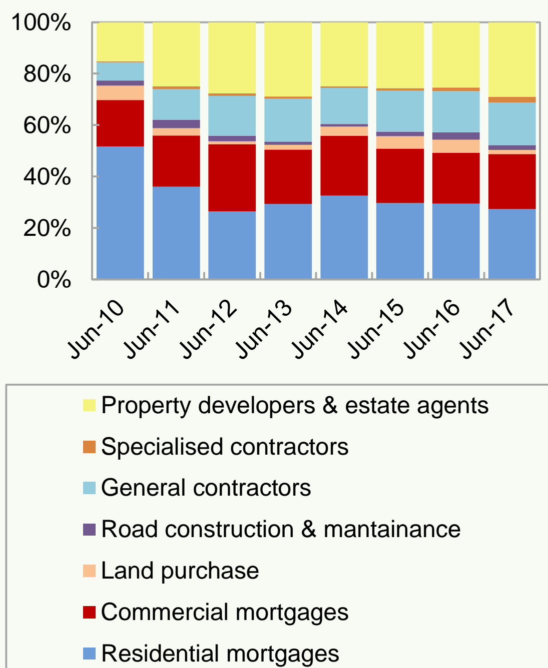
This chapter presents the highlights of a survey undertaken by BOU in 2017, which was targeted at selected commercial banks with significant exposure to the real estate sector, and borrowers within the sector, in order to appropriately determine the factors affecting the performance of credit to the sector and the likely policy implications.

5.2. Rationale

The loan exposure of banks to the real estate sector has risen significantly in recent years, driven by the growing need for financing commercial property developers and prospective homeowners to facilitate the acquisition of urban real estate.

Loans to the sector grew by 34.3 percent in the five years to June 2017, during which the sector's share of loans to total bank loans rose to 23.3 percent. Over the years, banks shifted lending within the sector increasingly away from residential mortgages and into the commercial real estate and property development categories.

Chart 44: Loans to the Uganda's real estate sector by category (percent)

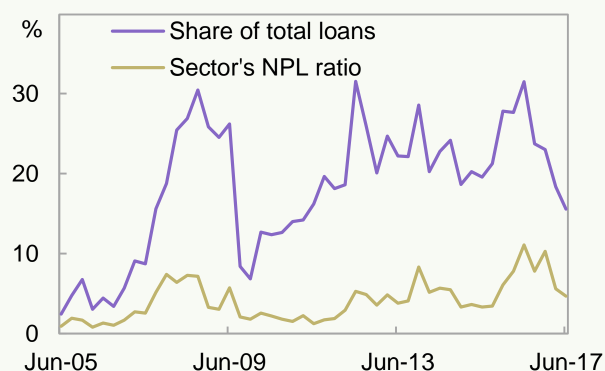


Source: Bank of Uganda

However, the recent slowdown in economic activity contributed to a gradual increase in defaults on loans extended to the sector. The ratio of non-performing loans to total loans for the real estate sector peaked at an all-time high of 11.1 percent in June 2016 and eventually declined to 4.7 percent in June 2017, following significant write-offs.

Indicators show that banks have constricted credit to the sector in response to the seemingly elevated levels of risk.

Chart 45: Real estate sector loans and NPLs (percent)



Source: Bank of Uganda

In light of the above, the key objectives of the survey undertaken by BOU were as follows:

a) To appraise the sector's NPL trends and other developments in the sector's credit conditions;

b) To assess commercial banks' success as regards foreclosure actions on real estate collateral and;

c) To enrich BOU's understanding of the underlying drivers of the real estate sector's performance.

5.3. Methodology

5.3.1. Scope of the survey

This was an exploratory survey, which covered ten commercial banks with the largest credit portfolios to the real estate sector and twenty largest borrowers in the sector in each bank.

The study covered secured lending to all aspects of the real estate sector including residential and commercial mortgages[16], general construction and land purchase between June 2014 and June 2017.

In terms of data collected, the survey collected both quantitative and qualitative data. Respondents were required to provide information on trends in NPLs in the sector, foreclosures, occupancy rates, rental income and collateral valuations. They were also asked to offer their outlook for the sector's performance, as well as recommendations on how to address the risks associated with lending to the sector.

5.3.2. Analysis of the data

A descriptive and quantitative analysis of the quantitative and qualitative responses was performed with respect to the variables in the survey.

5.4. Survey findings

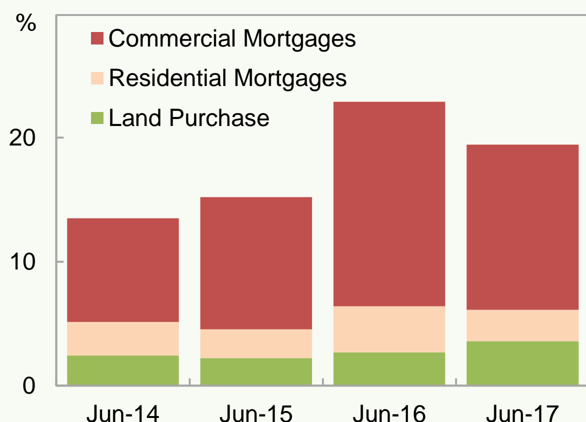
5.4.1. Changes in default rates

Commercial banks reported that in general, default rates on commercial mortgages increased significantly between June 2014 and June 2017, compared to those on residential mortgages and land purchase loans.

The data indicated that as at the end of June 2017, 13.3 percent of the reporting banks' commercial mortgages were non-performing. Comparably, the NPLs ratios for residential mortgages and land purchase were far lower at 2.5 percent and 3.6 percent respectively.

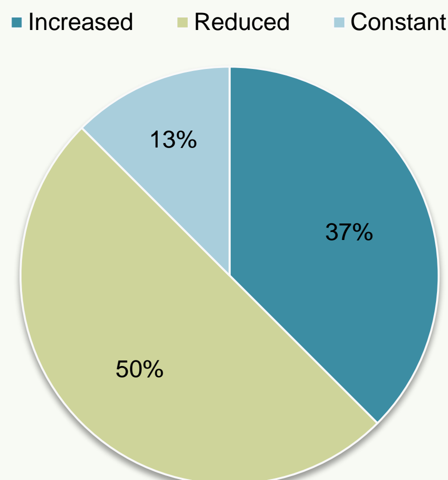
[16] Residential mortgages refer to loans taken out for investment in properties that people live in any form, whereas commercial mortgages are for investment in business premises of any kind in any form such as apartments, offices and lock-up shops (Bernhardt,1999)

Chart 46: NPL ratios from different real estate sub-sectors for the surveyed banks (percent)



Source: Bank of Uganda

Chart 47: Share of how property owners changed rental rates and sale prices between June 2016 and June 2017 (percent)



Source: Bank of Uganda

5.4.2. Trends in rental rates and sale prices

The respondents reported that over the last year, rental rates and sale prices for real estate property mostly reduced. The reduction in prices and rates was largely attributed to the falling demand for properties as a result of a contraction in credit and a slowdown in the economy.

Another factor raised by respondents was that the increasing unavailability of loans for real estate negatively impacted the size of transactions in the sector, partly reflected in price reductions.

In addition, the location of property also affected occupancy levels, with 25.0 percent of residential property developers reporting that properties in prime areas had lower occupancy levels. This, together with a substantial amount of cheaper rates in the city suburbs, was influential in their decision to reduce prices.

Other reasons given for reduction of rates and prices by commercial property owners was job cut backs and the exiting of some investors from the oil sector had driven rates down (8.0 percent).

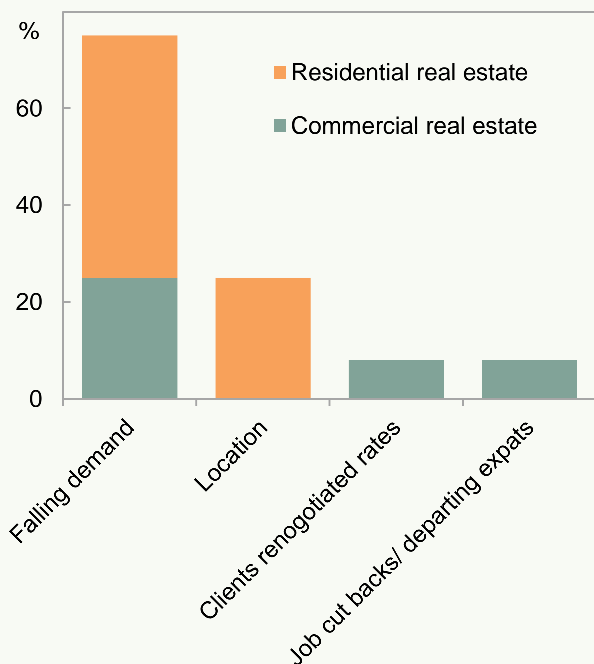
However, a small number of commercial and residential property owners reported that rental rates and sale prices increased or remained constant over the survey period. Of the property owners who increased rental rates, 40.0 percent did so in order to counter the depreciation of the Uganda shilling against the US dollar during the last half of 2016.

Others cited the rising cost of construction materials, high-quality finishing materials, and the increase in property tax had informed their decision to increase property rates.

Currency of rental rates and sale prices

Fifty per cent of commercial and residential property owners reported that they charge rent in US dollars, while 28 percent indicated that they accept both currencies, US dollars for multinational corporations and foreigners and shillings for Ugandan citizens.

Chart 48: Reasons for reductions in sale prices and rental rates by property type (percent)



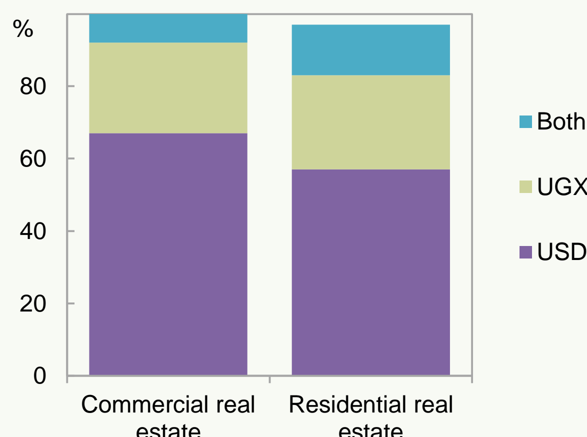
Source: Bank of Uganda

It should be recalled that the Parliament of Uganda amended subsection five of the Income Tax (Amendment) Act (2017) to include a clause prohibiting charging of rent in currency other than the Uganda shilling. However, most property owners and developers reported that they had no plans to change the way they charge rent. It remains to be seen what impact the amendments that come into force on 1st July 2017 will have particularly on real estate developers who typically finance their projects with foreign currency loans.

5.4.3. Borrowers' awareness of BOU's loan-to-value ratio policy

When asked whether they were familiar with Bank of Uganda's 75.0 percent LTV policy and its implications, all the surveyed borrowers submitted that they were not. They added that the LTV policy could explain why some banks had not extended full loan amounts applied for, thus affecting the completion of their property development projects.

Chart 49: Currency of rental rates and sale prices by property type (percent)



Source: Bank of Uganda

5.4.4. Causes of loan quality deterioration

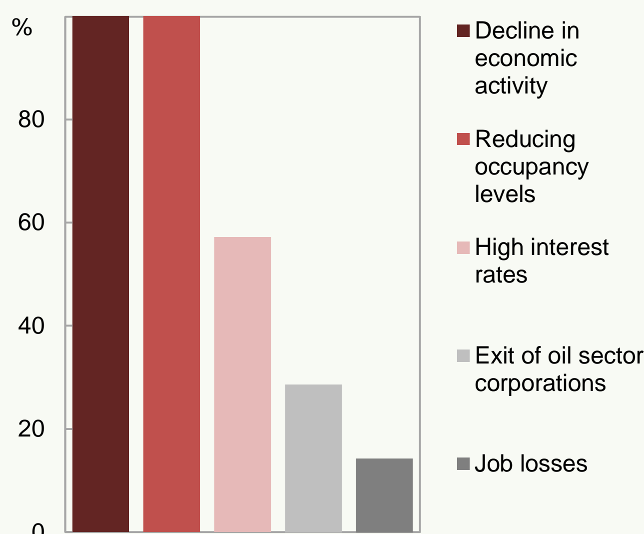
Tightened economic conditions

In the survey, all the respondents attributed the decline in performance of the sector in 2016/17 and the subsequent high levels of NPLs to a slowdown in the overall health of the economy. Both banks and borrowers reported that the economic conditions characterised by rising inflation, exchange rate volatility and the political instability in South Sudan (Uganda's largest importer), significantly affected business cash flows.

On the demand side, 25 percent of the residential mortgage borrowers had major business operations in South Sudan and revealed that the civil war in the country had partly impacted their ability to service their loans. Further, respondents cited the exit of various corporations from the oil and gas sector as having affected occupancy levels of residential complexes and office spaces in prime locations, whose target market comprises mainly multinational corporations and the expatriate community. On the other hand, 17 percent of the respondents indicated that delayed payments by the government to its

suppliers had greatly affected traders' revenues and their ability to meet their rent payment obligations regularly.

Chart 50: Responses to drivers of the real estate sector's drop in performance (percent)



Source: Bank of Uganda

On the supply side, the surveyed banks cited the above factors as well as rising levels of unemployment, for their decision to maintain high lending rates despite sustained monetary easing by BOU.

Occupancy rates

The survey participants indicated that the occupancy rates reduced in the year to June 2017, especially for shops, which was another key factor for the high loan default rates.

The survey showed that the average occupancy rates for residential properties (residential houses) reduced from 65.0 percent to 42.0 percent between June 2016 and June 2017. However, the occupancy rates for commercial real estate increased marginally from 58.0 percent to 62.0 percent.

The respondents noted that the winding down of several large retail businesses negatively affected occupancy levels, especially in the commercial space. The reduction in occupancy rates, coupled with delays by tenants to make regular rental payments, heightened the risk of default in the sector.

Sixty seven percent of the surveyed borrowers indicated that due to the stringent lending standards by the banks, they could not acquire the full loan amounts applied for and as such parts of their properties had been left unoccupied pending completion[17]. They added that this affected their projected rental incomes and their debt-servicing capacity.

Moreover, a few property owners reported that a number of prospective tenants had relocated to more affordable properties in the city suburbs, rendering properties in the central business district largely unoccupied.

Conversely, 17 percent of the borrowers reported increased occupancy rates, attributing it increased availability of credit as a result of Bank of Uganda's continued reduction in the CBR, from 15.0 percent in June 2016 to 10.0 percent in June 2017.

Table 22: Occupancy rates by property type (percent)

	Jun-16	Jun-17
Commercial real estate	58.0	62.0
Residential real estate	65.0	42.0

Source: Bank of Uganda

Demand for property

In order to gain insight into overall demand for property, participants were asked to comment on the

[17] Bank of Uganda's Lending Survey (2017) established that the building, mortgage, construction and real estate sector registered the highest net tightening (50.8 per cent) during the quarter ending June 2017.

number of inquiries by prospective clients for both purchase and occupancy over the past year. The respondents intimated that inquiries for purchase of residential houses started to increase in the second half of the year to June 2017. The increase in inquiries for residential houses and some commercial spaces was attributed to an infrastructural boom, particularly in road networks in sub-urban areas that were previously less popular with especially the medium and high income classes.

Commercial property owners, on the other hand, indicated that they had received fewer inquiries compared to the previous year.

5.4.5. Foreclosure trends

Only 45 percent of the banks surveyed completed foreclosures on collateral pledged against commercial and residential mortgages between July 2014 and June 2015 (Table 23). Most actions were taken on collateral pledged against residential mortgages between June 2016 and June 2017 compared to the year before. It was reported that the reduction in business cash flows available for portfolio growth meant that there were fewer buyers for repossessed properties during this period.

Table 23: Share of banks reporting completed foreclosure activity (percent)

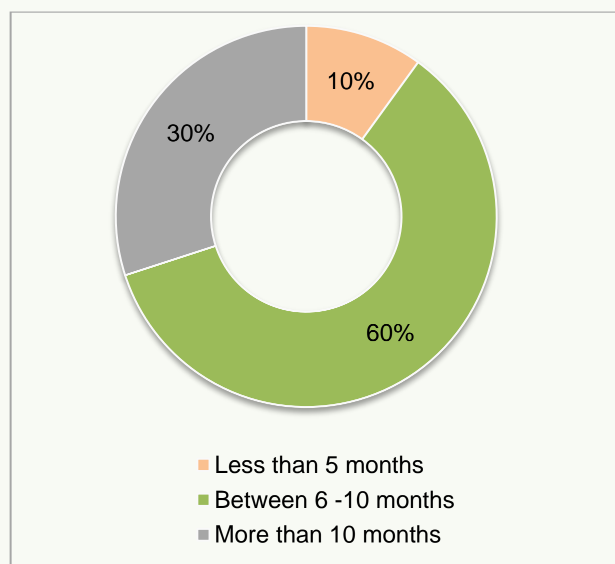
Category	Jun-15	Jun-16	Jun-17
Residential mortgages	50	80	80
Commercial mortgages	40	70	70
Land purchase	40	40	40

Source: Bank of Uganda

Average time to foreclose

Overall, the responding banks indicated that the properties foreclosed between June 2014 and June 2017 had been in the foreclosure process an average of 10 months. The majority of the banks (60 percent) indicated that the average time to foreclose was between 6 and 10 months, while 30 percent reported a longer time of more than 10 months. Only 10 percent of the banks reported a shorter time of less than 5 months over the same period. This indicates that real estate foreclosure processes remain a lag on loan recovery for banks.

Chart 51: Average time taken by banks to foreclose



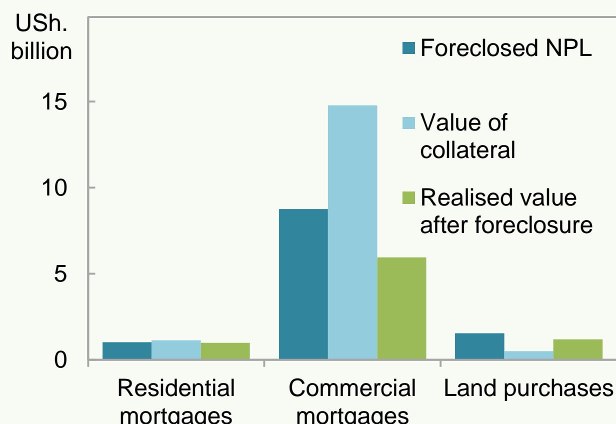
Source: Bank of Uganda

5.4.6. Variations between collateral and foreclosure values

Commercial banks reported that are challenges with obtaining correct valuation for property, with many reports of inflated values. On average, the largest discrepancy in property value was reported to be for commercial mortgages.

This affects loan recovery. On average, after foreclosure, banks reported that they were able to recover only 40.2 percent of the value of collateral pledged on commercial mortgages, while for residential mortgages, the average was 86.3 percent. On the other hand the value realised on collateral pledged against land purchase loans exceeded the value of the collateral itself by over 100.0 percent

Chart 52: Realised values after foreclosure for the largest NPLs



Source: Bank of Uganda

Banks suggested that falling property prices and the overvaluation of collateral at loan disbursement were key issues in the differences realised. This also implies that the LTV ratios on these loans were much higher than 100 percent.

Most commercial banks indicated that values realised have been on a downward trend between June 2014 and June 2017 and implied that a slump in economic activity had sharply reduced disposable income and effectively eroded demand for real estate properties.

However, some banks reported that the involvement of clients in the foreclosure processes along with the utilization of law firms to conduct the process had been crucial in the disposal of properties at relatively higher offers.

5.4.7. Banks' perceptions of the property valuation process

The overall sentiment from the survey was that the valuation profession and practices in Uganda lacked transparency and, for the most part, involved conflict of interest. The responding commercial banks revealed that property valuations were highly subjective, speculative and that property prices in most cases were distorted and not a true reflection of real market value. Some banks had resorted to inserting professional indemnity clauses in contracts with banks appraisers in order to improve standards.

Suggestions for improvement in the valuation standards

All the banks stated that there is a need to adopt standard valuation procedures for purposes of consistency and improvement in the quality of valuation reports. They suggested that the valuation processes in the country would greatly benefit from the movement to and registration of appraisers into an international valuers standards certification board.

Further, a proposal was made to create a list of empanelled valuers by the Uganda Bankers' Association (UBA) and subsequently delist any unscrupulous valuers. The Bank of Uganda was also requested to share market trends including data on forced sale valuations[18] more frequently to allow for comprehensive assessments of real estate markets. The banks felt that it was necessary to incorporate changes in land laws while appraising properties.

5.4.8. Outlook for the real estate sector

The respondents were asked to comment on their expectations on the performance of the real estate sector in the coming year.

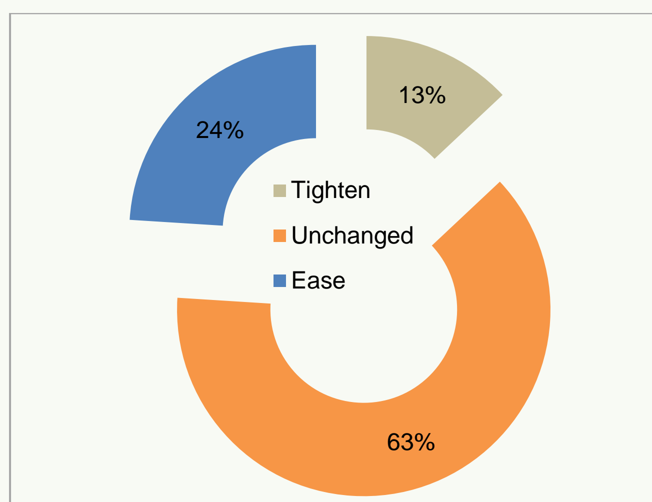
Commercial banks' expectations for changes in lending standards

On the credit supply side, the survey results showed that 63 percent of the responding banks indicated that they expected lending standards for real estate over the next year to remain largely unchanged compared to the previous year due to the prevailing

[18] A forced sale valuation is where an item is valued on the basis where no reserve has been placed on the item/asset and the bidders determine the value on a 'where is as is basis' (Asset valuations, 2017)

poor market conditions. However, 24 percent expected to ease standards in order to boost credit in the real estate sector. The expected easing was on account of easing monetary policy and the availability of funds from the International Finance Corporation (IFC)[19] meant to support investments in the real estate sector. These responses are in line with Bank of Uganda's Bank Lending Survey for June 2017[20], with

Chart 53: Expectations of banks for lending standards



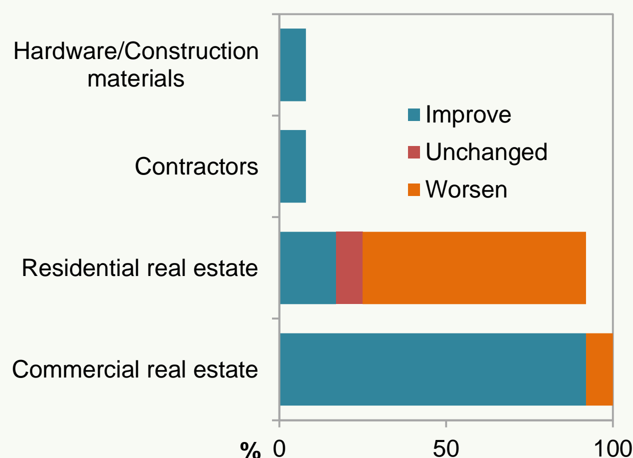
Source: Bank of Uganda

A minority of banks expected their lending standards to tighten further indicated that the loan distress in the sector had negatively affected the borrowers' capacity to service their loans, resulting in the worsening of banks' asset quality.

Borrowers' expectations for changes in real estate sector performance

The majority of commercial property owners projected an improvement in the performance of the sector. Meanwhile, residential property owners expressed the belief that returns from the sector would remain unchanged.

Chart 54: Expectations of borrowers for real estate sector performance



Source: Bank of Uganda

Respondents who expected an improvement in the performance of the sector cited a number of facts. These include;

a) The planned completion of a regional oil pipeline and issuance of exploration licenses to new players is expected to have a positive spin off on demand for commercial and residential properties.
b) Increased government expenditure on infrastructure and electricity generation[21], is expected to support sustained economic growth and improve cash flows.
c) The rapid increase in population and a growing

---

[19] The International Finance Corporation (IFC) is an international financial institution that offers investment, advisory, and asset-management services to encourage private-sector development in developing countries. In 2016, the IFC invested $40 million in equity in Growthpoint Investec African Properties Limited, a Pan-African real estate investment vehicle. The funding is intended to help the company to invest in income-producing commercial real estate assets in Sub-Saharan Africa (AVCA-AFRICA, 2016)

[20] Bank Lending Survey Report June 2017

[21] UETCL, (2017), Uganda's generation capacity to reach 3,500MW by 2018. Available at http://www.uetcl.com/index.php/sample-sites/89-news-events/151-uganda-s-generation-capacity-to-reach-3-500mw-by-2018

middle class is expected to drive the demand for real estate up.

d) Improved productivity is expected to enhance demand for warehouses and top floors of city arcades as storage spaces for processed organic products.

e) BOU's accommodative monetary policy stance is expected to boost private sector credit. The availability of more credit to the sector would increase the availability of investible funds especially, for house and land purchase.

.

5.4.9. Conclusion and Policy Implications

The survey showed that the performance trends of the real estate sector closely follow the trend of economic growth, as expected. The results further give rise to several implications:

a) Valuation of properties pledged as collateral

There is need to establish industry standards for property valuers in order to enhance and enforce minimum standards. This could include registration of appraisers, certification and training by a standards certification board. This would go a long way in countering the effects of fraudulent collateral valuations.

Commercial banks also emphasised the need for Bank of Uganda's engagement with the Ministry of Lands, Housing & Urban Development as regards inefficiencies in the titling of properties in the country.

b) Payment of foreign currency loans

Borrowers need to collect rent in the currencies in which the loans are denominated which would then reduce the inherent foreign exchange risks on loan repayment.

c) Occupancy rates

Occupancy rates are a good indicator of loan performance and banks need to compile data on this indicator regularly and track it.

d) Cost of credit

Despite the reduction in the CBR, commercial banks' lending rates remained very high and therefore hampered borrowers' capacity to service their loans. The short term nature of bank lending also affects loan performance for commercial loans, given that most of these loans are not long term while returns on investments in the sector are expected over a longer time period.

e) Revision of credit classification guidelines

Many borrowers requested Bank of Uganda to consider revising the credit classification guidelines to allow for some degree of flexibility when classifying loans as non-performing. They suggested that longer term loans in the real estate sector warrant an extended period, different from that for short-term borrowers, before the loan is considered as non-performing.

f) Foreclosure remains a challenge

The average time it takes a bank to complete foreclosure on a real estate is about ten months. This indicates that real estate foreclosure processes remain a lag on loan recovery for banks.

g) Loan-to-Value Ratio

The survey showed that banks have implemented the limits on loan-to-value Ratio (LTV) instituted by BOU effectively. However, awareness of this tool among borrowers remains low. There is need to improve public awareness about this measure.

Going forward, Bank of Uganda will study the results of this survey and take policy actions to enhance the resilience of the financial sector to risks from exposure to the real estate market.

6. STATISTICAL APPENDICES

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

		June 2015	Sept 2015	Dec 2015	Mar 2016	June 2016	Sept 2016	Dec 2016	Mar 2017	June 2017
Regulatory capital to risk-weighted assets	Uganda	21.3	20.1	21	21.8	21.7	22.5	19.8	22.8	23.6
	Kenya	18.9	18.7	18.8	18.8	18.1	19.0	18.7	19.4	19.6
	Tanzania	17.6	18.6	18.8	20.0	19.2	19.1	19.9	20.8	20.3
	Rwanda	24.3	24.2	22.5	24.9	23.3	22.2	23.1	22.4	20.7
	Burundi	19.5	19.2	18.1	22.3	20.8	20.2	22.4	23.3	22.0
NPLs to total gross loans	Uganda	4	3.8	5.3	6.9	8.3	7.7	10.5	6.3	6.2
	Kenya	5.7	5.4	6.8	7.6	8.4	8.8	9.1	9.6	9.9
	Tanzania	6.7	6.6	7.9	8.4	8.7	9.1	9.6	11.0	10.6
	Rwanda	5.9	6.3	6.2	6.2	7.0	7.4	7.6	8.1	8.2
	Burundi	13.3	14.2	18.6	18.4	19.2	19.5	21.6	13.7	11.5
Return on assets (ROA)	Uganda	3.8	2.7	2.6	2.8	2.2	2.4	1.3	1.4	1.7
	Kenya	3.3	3.3	2.9	3.4	3.2	3.3	3.1	2.9	2.8
	Tanzania	3.0	2.8	2.6	3.5	3.0	2.5	2.3	2.4	2.3
	Rwanda	2.4	2.3	2.1	1.9	1.7	1.9	1.7	1.8	1.7
	Burundi	1.2	1.7	1.8	0.6	0.8	0.8	1.8	0.5	1.4
Return on equity (ROE)	Uganda	24.6	17.1	16	16.8	13.8	14.9	8.3	8.3	9.9
	Kenya	28.3	27.4	23.8	27.7	27.2	27.0	24.8	22.2	22.3
	Tanzania	15.8	14.2	12.5	18.2	15.3	12.1	10.7	11.2	10.4
	Rwanda	13.1	12.7	11.2	9.8	9.2	10.0	8.8	10.1	9.6
	Burundi	8.1	11.8	12.0	3.8	5.3	5.6	11.2	4.7	10.2

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

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

	June 2015	Sept 2015	Dec 2015	Mar 2016	June 2016	Sept 2016	Dec 2016	Mar 2017	June 2017
Capital Adequacy									
Regulatory capital to risk-weighted assets	21.3	20.1	21	21.8	21.7	22.5	19.8	22.8	23.6
Regulatory tier 1 capital to risk-weighted assets	18.8	17.6	18.6	19.1	19.0	19.8	17.3	20.4	21.4
Leverage ratio	11	10.6	11.1	11.4	10.8	11.1	9.6	11.0	11.4
Asset quality									
NPLs to total gross loans	4	3.8	5.3	6.9	8.3	7.7	10.5	6.3	6.2
NPLs to total deposits	2.9	2.8	3.9	4.9	5.8	5.4	7.4	4.1	4.0
Sectoral distribution of gross loans (%)									
Agriculture	9.3	9.3	9.5	9.9	9.8	9.7	9.8	11.2	11.3
Mining and quarrying	0.5	0.5	0.5	0.6	0.6	0.5	0.5	0.6	0.6
Manufacturing	16.1	15.8	14.8	14.7	14.6	13.9	13.7	13.0	13.3
Trade	19.5	19.6	18.7	17.7	17.9	18.6	18.6	18.8	18.9
Transport and comm.	5.2	5.9	5.8	6.6	7.1	7.4	7.5	7.0	6.8
Building and construction	23.2	23.5	24.1	24.3	23.6	23.4	23.4	20.7	20.5
Personal loans	15.2	14.8	15.2	15.6	15.9	16.5	16.5	18.1	18.5
Others	9.3	1.4	1.5	1.6	1.3	0.8	0.7	1.3	0.7
Large exposures to total capital	126.4	139.3	123.5	123.9	121.5	118.7	133.2	99.8	97.5
Earnings & profitability									
Return on assets	2.8	2.7	2.6	2.8	2.2	2.4	1.3	1.4	1.7
Return on equity	17.7	17.1	16	16.8	13.8	14.9	8.3	8.3	9.9
Net interest margin	10.9	11.0	11.3	11.6	11.9	12.3	12.8	12.7	12.3
Cost of deposits	3.3	3.2	3.3	3.4	3.4	3.4	3.5	3.3	3.1
Cost to income	73.8	68.5	69.2	75.3	78.4	77.0	84.8	84.4	81.9
Overhead to income	48.1	48.2	48.7	48.0	47.9	47.5	47.5	47.7	48.4
Liquidity									
Liquid assets to total deposits	46.4	45.4	46.4	42.5	43.4	45.4	51.5	48.8	50.1
Total loans to total deposits	72.8	73.6	73.1	71.6	70.2	70.1	70.8	65.4	64.2
Market Sensitivity									
Foreign currency exposure to regulatory tier 1 capital	-5.7	-3.4	-5.9	-7.6	-6.2	-7.1	8.5	-8.1	-7.0
Foreign currency loans to foreign currency deposits	79.8	78.0	77.6	77.8	77.5	75.6	79.3	73.4	72.1
Foreign currency assets to foreign currency liabilities	101.4	102.7	101.8	97.4	96.7	96.0	99.2	96.7	91.8

Source: Bank of Uganda

APPENDIX 3: Commercial banks' quarterly balance sheet

	Jun 15	Sep 15	Dec 15	Mar 16	Jun 16	Sep 16	Dec 16	Mar 17	Jun 17
ASSETS (USh. Billion)									
Cash & cash assets	738.5	799.4	811.3	748.8	698.3	708.7	810.8	743.3	809.4
Balances with BOU	2025.4	2241.9	1982.6	2157.6	2727.7	2582.7	2858.7	2945.1	2917.3
Due from financial institutions	2583.2	2621.7	2634.8	2390.3	2244.8	2074.6	2592.3	2541.4	2243.7
Government securities	4283.6	3901.4	4064.8	4542.6	4965.8	5262.2	5105.3	5349.3	5141.8
Total gross loans & advances	10517.5	9851.7	9501.8	9435.2	9646.6	9797.7	10249.6	9661.6	10020.8
LESS: Provisions	-250.4	-231.5	-285.6	-401.5	-570.6	-519.1	-820.2	-352.5	-351.6
Net loans & advances	10267.1	9620.2	9216.2	9033.7	9076.0	9278.6	9429.5	9309.1	9669.2
Net fixed assets	886.5	914.2	925.9	995.3	992.5	1003.0	838.5	942.2	818.6
Other assets	817.6	769.9	691.9	713.2	776.2	804.9	761.4	1171.3	2226.0
TOTAL ASSETS	**21601.9**	**22313.2**	**21722.2**	**21896.0**	**22794.4**	**22990.4**	**23689.2**	**24206.4**	**24846.9**
LIABILITIES (USh. Billion)									
Deposits	14450.9	15247	14821.1	14937.4	15538	15726.6	16235.7	16550.2	17141.8
Due to financial institutions	686.8	543.3	654.0	455.7	526.5	575.8	595.5	658.4	594.2
Administered funds	1622.3	1661.4	1255.9	1212.3	1194.6	1068.2	1063.3	1019.3	1108.6
Other liabilities	1515	1390.8	1398.1	1647.4	1812.5	1653.3	1715.8	1993.2	1582.1
TOTAL LIABILITIES	**18275.1**	**18843**	**18129.1**	**18252.8**	**19071.8**	**19024.0**	**20027.3**	**20107.3**	**20627.4**
CAPITAL (USh. Billion)									
Paid-up capital	1336.6	1337.9	1346.8	1346.8	1391.3	1410.0	1414.6	1221.0	1255.8
Share premium	110.1	111.5	115.4	115.4	145.9	145.9	145.9	317.4	317.4
Retained reserves	1480	1476.7	1446.6	1839.7	1775.0	1781.7	1578.5	2161.3	2109.8
Other reserves/subordinated debt	130.3	124.7	143.2	176.9	196.1	195.1	218.9	214.4	229.9
Profit – Loss (current year)	269.8	419.9	541.1	164.4	214.2	433.7	303.9	185.0	306.6
TOTAL SHAREHOLDERS' FUNDS	**3326.8**	**3470.7**	**3593.0**	**3643.2**	**3722.6**	**3966.4**	**3661.8**	**4099.0**	**4219.5**
OFF BALANCE SHEET ITEMS (USh. Billion)									
Letters of Credit	487.8	565.4	494.0	431.2	390.0	353.5	337.2	292.2	336.3
Guarantees & performance bonds	1672.3	1819.6	1841.3	2143.6	2280.5	2368.5	2548.1	2666.8	2874.1
Unused loans/overdrafts commitment	1047.5	1504.9	1325.9	1484.2	2020.7	2347.8	2079.0	1961.6	1838.6
Other off balance sheet items	228.7	175.9	168.4	172.0	97.6	281.0	148.4	318.0	466.2
TOTAL OFF BALANCE SHEET ITEMS	**3436.2**	**4065.8**	**3829.6**	**4231.1**	**4788.8**	**5350.8**	**5112.7**	**5238.6**	**5515.3**

Source: Bank of Uganda

APPENDIX 4: Commercial banks' quarterly income statement, year-on-year figures

	Jun 15	Sep 15	Dec 15	Mar 16	Jun 16	Sep 16	Dec 16	Mar 17	Jun 17
INCOME (USh. Billion)									
Interest income									
Advances	1551.3	1642.4	1722	1780.3	1839.8	1855.6	1868.8	1849.7	1826.3
Government securities	465.8	481.3	497.6	531.4	570.1	641.4	689.3	715.6	722.9
Deposits abroad	9.7	10.7	12.0	14.7	14.9	16.0	17.3	17.8	19.2
Other	98.2	70.8	68.8	77.3	95.1	109.7	117.7	122.1	125.6
Charges, fees & commissions	403	413.3	419.3	429.1	436	432.1	429.9	435.7	493.1
Foreign exchange income	210.8	251.8	257.6	262.8	264	223.5	219.7	202.5	171.7
Other income	207.3	155.3	147.9	185.6	198.6	218.1	206.2	218.6	226.7
TOTAL INCOME	**2946**	**3093.1**	**3196.6**	**3352.4**	**3487.5**	**3557.2**	**3603.8**	**3612.4**	**3633.3**
EXPENSES (USh. Billion)									
Interest expense on deposits	441.2	449.4	467.6	490.1	509.2	526.7	539.6	526.7	513.5
Other interest expenses	162.6	178.3	189.8	192.3	189.6	178.0	169.3	165.5	162.1
Provisions for bad debts	153.8	172.3	217.7	231.1	364.1	345.2	637.2	634.6	541.1
Salaries, wages, staff costs	612.1	626.8	646.9	660.5	684.5	695.8	720.1	736.3	748.4
Premises, depreciation, transport	262.1	278.6	296.5	306.7	321.7	324.1	322.2	324.7	325.8
Other expenses	543.3	586.5	612.6	642.6	664.0	667.5	668.4	660.8	683.6
TOTAL EXPENSES	**2175.0**	**2292.0**	**2431.2**	**2523.3**	**2733.0**	**2737.3**	**3056.8**	**3048.6**	**2974.5**
ADD: Extraordinary credits/charges	0	0	0.0	0.0	0.0	1.0	0.0	0.0	0.0
Net profit before tax	771	801.1	765.3	829.1	754.5	818.9	546.0	562.9	657.8
LESS: Corporation tax	214.8	245.4	224.1	242.8	268.8	263.7	243.9	250.3	263.3
NET PROFIT AFTER TAX	**556.3**	**555.7**	**541.2**	**586.3**	**485.6**	**555.1**	**302.1**	**312.6**	**394.4**

Source: Bank of Uganda