BANK OF UGANDA

Opening Remarks by Dr. Louis Kasekende, Deputy Governor, Bank of Uganda

At the World Bank Uganda Financial Sector Review Workshop

Kampala, Uganda

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Good morning ladies and gentlemen,

I would like to thank everyone who has contributed to the World Bank's Financial Sector Review which we will be discussing at this workshop. I am sure that it will provide many valuable insights which will help us to formulate policies which can strengthen the financial sector and enhance its contribution to economic development.

I want to comment briefly on some of the findings of the Financial Sector Review, based on what is stated in the Executive Summary, as I have not yet had a chance to see the full report.

As the review notes, financial intermediation has grown quite rapidly in Uganda over the last decade, as banks have both mobilized more deposits and intermediated a higher proportion of their deposits. In 2005 the banking system lent out only 38 percent of its deposits as loans. By March 2015 this had risen to 73 percent. In real terms – after taking account of inflation – bank credit to the private sector has increased more than four and a half times in the last 10 years. Nevertheless, bank lending is still very low in comparison to GDP and, as noted in the review, access to credit is a constraint for the business sector.

I disagree with the conclusion of the review that the priority for expanding bank credit should be small firms and households, rather than the corporate sector. Small firms and household enterprises have proliferated over the last 10 years. The data in the UBOS Census of Business Establishments indicate that, while the number of registered businesses in Uganda increased three fold in the 2000s, most of the growth was concentrated in informal sector micro-enterprises rather than the medium and large scale enterprises. It is growth of the latter which is essential for both creating formal sector employment and generating the technological upgrading which drives structural change in the economy. Hence it is imperative that the medium and large scale enterprises can access the financial services they need to support their growth.

The review notes that government securities comprise about 20 percent of commercial banks' asset portfolios and implies that lending to government is crowding out lending to the private sector. I have not seen any convincing evidence that this is actually the case. For crowding out to take place, one would have to argue that government securities are substitutes for loans to the private sector, so that a lower government borrowing requirement would induce banks to extend more credit to the private sector rather than invest in some other type of asset, or reduce their

liabilities. But government securities have many features – their relative lack of risk, their liquidity, their lower capital requirements – which do not make then close substitutes for loans to the private sector. Provided that government can maintain its borrowing requirement at levels which are consistent with demand for government debt by the private sector, including demand from commercial banks, the private sector should not be crowded out from credit markets.

The review notes that the banking system in Uganda is highly concentrated. In fact there has been a marked reduction in concentration over the last 10 years. The Herfindahl-Hirschman Index of bank asset market concentration fell by nearly 50 percent over the last 10 years, from 1,725 in 2005 to 885 in 2015 (a higher score indicates a higher degree of market concentration). The reason for the fall in market concentration has been the growth of some of the medium sized banks, which have taken market share from the traditionally dominant large international banks.

Stronger competition in the banking industry, which is reflected in the fall in market concentration, has led to a fall in banks' returns on assets and an even larger fall in returns on equity. Returns to bank equity have fallen by about half over the last decade, from 30 percent in 2005 to 15 percent in 2014.

The fall in returns on bank equity over the last 10 years reflects three important developments. First, greater competition has squeezed bank interest margins, by about three percentage points between 2005 and 2015, mainly because banks have had to pay higher interest costs to mobilize deposits. Second, competition has forced banks to expand their branch networks, in order to attract and retain customers. In 2005 there were 156 bank branches in Uganda. Last year there were 560 bank branches. The huge expansion in the physical presence of banks in the country is costly, as noted in the review, and is one of the reasons why banks have made little progress in reducing their high operating costs as a share of their assets. Third, in the face of declining interest rate margins and stubbornly high operating costs, banks have sought to maintain their profits by increasing intermediation, given that loans offer higher earnings than most other assets. But the increase in intermediation has raised the share of risk assets in banks' asset portfolios, forcing them to hold more capital as a share of their total assets. It is the combination of lower returns on assets and an increase in capital to asset ratios which has brought about such a steep fall in banks' return on equity over the last decade.

To conclude, I think that if we look at the development of the banking sector over the long term, tangible progress has been made. In particular, intermediation has increased markedly and

competition has strengthened, to the benefit of bank customers. At the same time, the stability of the banking system has been enhanced with most banks being well capitalized. Over the course of the last 10 years, only two very small banks have failed. This is a solid foundation on which to build. I hope that over the coming decade we will achieve further strong growth in intermediation, especially involving lending to the corporate sector, a diversification of financial services and a gradual fall in bank operating costs which will make possible a further reduction in interest rate spreads.

Thank you for your attention.