BANK OF UGANDA

Remarks by Deputy Governor,

Dr Louis Kasekende, at the

3rd Regional CIS Conference;

on

"Value of Credit Information Services in Financial Sector Stability"

Nairobi; February 23, 2016

Good morning ladies and gentlemen,

Let me begin by commending everyone who has worked tirelessly in organising this conference. I most sincerely thank Governor Patrick Njoroge for the warm hospitality accorded to us. In my brief remarks, I will restrict myself to underpinning the value of credit information services in risk management and financial sector stability, with specific reference to policy and practical interventions in Bank of Uganda while benchmarking against international best practise

Credit risk is by far the most important type of risk facing banks in Uganda. The bank failures of the late 1990s were caused by bad debts, including large insider loans. There were serious deficiencies in credit reporting in the failed banks, including failure to disclose non-performing loans (NPLs) and failure to classify NPLs properly. In some of the failed banks, loans were not even disclosed on the balance sheet.

Beginning in the early 2000s, the BOU modernised its banking supervision, with the introduction of risk based supervision. As you are all aware, risk based supervision involves focusing scarce supervisory resources on those banks which pose the greatest risk and, within each bank, the specific operations which pose the greatest risk. That entails a strong focus on monitoring the credit risk faced by banks and evaluating the quality of its credit management.

In addition, risk based supervision requires that bank supervisors develop a risk profile of each bank and can monitor its financial health and potential risks, and the risks and soundness of the banking system as a whole, through off-site reporting and onsite examinations. Off-site reporting provides both early warning indictors of possible bank distress and can guide the activities of on-site bank inspectors.

The BOU has developed a comprehensive set of data requirements that must be submitted by banks and other supervised financial institutions on a weekly, monthly and quarterly basis. These indicators include the standard financial stability indicators.

Given the importance of credit risk, data reporting requirements emphasise credit data, including: loans by currency of denomination, loans by sector of borrower, loan growth, large loans, insider loans, non performing loans, specific provisions for NPLs and interest rates on loan disbursements. The loan data is also used in the BOU's quarterly stress test on banks, which include tests of shocks to the credit portfolio, such as default by one or more large borrowers, an increase in NPLs, changes in interest rate margins, etc.

The quantitative data submitted by banks to the BOU, backed up by on-site inspections, is essential to enable the BOU to enforce compliance with prudential regulations. Prudential regulations pertaining to bank lending include: i) minimum capital to risk assets ratios, ii) constraints on large exposures to a single or related group of borrowers, iii) constraints on insider lending; iv) a cap of the foreign currency denominated (FX) loans to FX deposit ratio, v) restrictions on the type of borrowers who can access FX loans from banks, and vi) loan classification and provisioning requirements.

The BOU has also begun to assess, on a pilot basis, the loan to value ratios of banks (*i.e. loan amount as a ratio of the market value of collateral*). In the future, the BOU may introduce caps on loan to value ratios as a macro-prudential policy measure (i.e. to limit aggregate credit growth).

Risk based supervision also emphasises qualitative aspects of ensuring financial soundness in banks. The BOU issues guidelines for risk management in banks, covering risk management strategies, the responsibilities of boards of directors to monitor risk, etc.

Overall, since the early 2000s, the increased focus on the supervision and credit risk of banks has generated a sustained improvement in loan performance. At the aggregate banking system level, NPLs have averaged only 3.8 percent of total loans between the start of 2002 and the end of 2015 (compared to more than 15 percent in the late 1990s), and as a consequence, bank failures have been limited to only a few very small banks.

Distinguished Governors, Financial markets are characterised by widespread informational imperfections, such as informational asymmetries. These informational imperfections create market failures, such as suboptimal levels of lending and, for some borrowers, credit rationing. The provision of credit information services (CIS) can reduce informational imperfections and thus mitigate market failure in financial markets. And to be effective, a CIS must collect information on borrowers from all possible lenders, past and present.

As such, a Credit Reference Bureau (CRB) was established in 2009. All banks and other licensed financial institutions are required, under the banking legislation and its subsidiary regulations, to submit data on non-performing loans and on customers involved in financial malpractices to the CRB in a standard format. In some cases, banks had to modify their IT systems to generate the requisite data. The BOU requires that all financial institutions must obtain a credit report about a borrower before any lending is approved. The credit reports compiled by the CRB assist banks to better evaluate credit risk, thereby helping to alleviate the credit information asymmetries which characterise financial markets and create market failures. They also help banks to control multiple borrowings, whereby a single borrower obtains credit from multiple banks without each individual bank being aware of the borrower's liabilities to other banks. This was a major problem in the past.

In vetting Board members and other senior managers of supervised financial institutions, BOU requests for credit information from the CRB to assess their credit worthiness.

The credit reports from the CRB have also been valuable in promoting group lending by micro-finance deposit taking institutions (MDIs), which is a substitute for collateral based lending. Borrower groups collectively assume responsibility for repaying the loans if any individual member of the group defaults. To reduce moral hazard, the lender evaluates the credit history of all prospective individual members of borrower groups, using reports from the CRB, before approving credit to the group members.

In further supporting supervision and financial stability assessment, BOU looks at aggregate credit levels of borrowers using information from the CRB. For each individual supervised financial institution, we assess the impact on the financial viability of each institution by the large borrowers, as well as, the impact of default of a Single large borrower on the financial sector as whole. From the foregoing, Credit information services (CIS) have clear positive externalities especially for financial stability.