Emmanuel Tumusiime-Mutebile: Recent initiatives designed to increase the efficiency of the Ugandan banking system

Address by Mr Emmanuel Tumusiime-Mutebile, Governor of Bank of Uganda, to the Annual Bankers' Dinner, Kampala, 4 March 2005.

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Distinguished Guests,
Fellow Bankers,
Ladies and Gentlemen

> *An after dinner speaker who was new to the art of public speaking stood up and having suitably saluted his audience stopped dumbfounded. Presently, however, he composed himself sufficiently to begin his speech. "A few hours ago only the Lord and I knew what I was going to say ….. but now the Lord only knows".*

It is always an honour for me to be a guest speaker at this annual event where the banking fraternity gets an opportunity to interact and exchange views in a relaxed environment away from each one's busy place of work.

At a similar event last year, I was challenged to speak about the Basel II Accord or the New Capital Accord as it is referred to by many of you. I vaguely recall the levels of boredom which showed on the faces of most of those who were present that evening, which is something I do not wish to see repeated tonight. This time round I will make life easy for everyone by talking about mundane things

Let me first report on the state of the financial sector. Substantive progress has been made in building a sound and profitable financial system. In the 1980s and 1990s, the banking system was under severe stress; many banks were riddled by high levels of non-performing assets and some banks were insolvent. As a result, in 1995, two banks were seized by Bank of Uganda. The Uganda Commercial Bank had to be restructured and recapitalised by the Government and the Non-Performing Assets Recovery Trust was created in 1995 to recover unpaid debt totaling the equivalent of US$34million. UCB deposits at that time represented over 20% of the total deposits of the banking system and the feeling was abroad that it was too large to be allowed to fail. In 1998 and 1999, four more banks, accounting to about 12% of the total deposits of the Banking System, were intervened by the Bank of Uganda and closed.

The Central Bank also intervened in UCB and attempted another rescue operation.

During this period, the Bank of Uganda of Uganda instituted an internal programme to strengthen Banking Supervision with substantial resources being put into training and moving towards a risk-based approach to Banking Supervision.

The resolution of the Bank of Uganda intervention into the Uganda Commercial Bank through the sale of its assets to Stanbic Bank further strengthened the financial sector. Stanbic has not only retained all the branches of UCB, it has improved service quality, outreach and efficiency. They have also successfully introduced Automatic Teller Machines throughout their branch network which has substantially increased convenience and reduced transactions costs.

As a result of these reforms, public confidence in the financial sector has greatly improved. Over a period of the last ten years, the banking sector has registered a tremendous increase of Shs.2,591.2bn. in total assets from Shs.723.7bn. in 1995 to Shs.3,315.0bn. in 2004. Total deposits grew by Shs.2,052.9bn. from Shs.383.0bn. to Shs.2,435.9bn. during the same period while total loans went up by Shs.673.2bn. from Shs.303.5bn. to Shs.976.7bn.

Over the period 1988 to 2004, non-banking financial institutions recorded growth of assets amounting to Shs.139.02bn. from Shs.56.78bn. to Shs.195.79bn. Deposit liabilities grew by Shs.94.46bn. from Shs.17.89bn. to Shs.112.35bn. The loan portfolio grew by Shs.72.245bn. from Shs.18.99bn. to Shs.91.24bn. over the same period.

Overall, the asset quality and profitability of the Commercial Banks have substantially improved, although it is troubling to see that banks' balance sheets still reflect a strong preference for liquid and low-risk assets, and the margin between interest rates paid on deposits and lending rates is still unconscionably high. The quality of the bank's risk portfolio has improved tremendously with non-performing assets ratio falling from 29% of the portfolio in 1998 to 2.6% in September 2004.

However, the maturity structure of loans, and the degree of concentration need to be reviewed. On the maturity structure only 12% of all loans, 35% of loan volume, 17% of total deposits and less than 0.5% of time deposits have a maturity structure of more than one year.

There is also a high degree of concentration on both the loans and deposit sides. Large exposures represent 44% of all loans, with loans to the largest five borrowers accounting for 24% of total loans. On the deposit side, the largest five depositors account for 21% of all deposits. This level of concentration poses a risk to the safety and soundness of banks. To deal with this threat, I will not hesitate to use the powers conferred upon the Bank of Uganda by the Financial Institutions Act 2004 to force a reduction in loan concentration.

Let me now review a number of recent initiatives which are designed to increase the efficiency of the banking system.

The National Payments System:

The Bank of Uganda has established a Real Time Gross Settlement system in Uganda in abbreviation referred to as the RTGS. The RTGS is an inter-bank credit transfer system in which large payments and time-sensitive payments are settled immediately (real time) and individually (on a gross basis).

The RTGS system has advantages of:

- doing away with the long clearing cycles for traditional settlement instruments
- strengthening the management of risk in payment systems
- promoting economic efficiency and competitiveness through expeditious transfer of funds , and
- enabling Bank of Uganda to improve the efficiency of management of monetary policy through timely availability of data on the stock of money flows in the financial system.

From the foregoing, the RTGS system is a critical national infrastructure that will promote macroeconomic stability and the further development of the financial sector. The RTGS went live on 21st February 2005 and is now fully operational.

The performance of the Uganda National Inter-bank Settlement System in its first week of operation has been outstanding. On its first day of implementation, 86.4% (i.e. nearly UGX 220 billion) of the inter-bank payments that were settled at Bank of Uganda were channeled through the UNIS system. Such a level of performance on the first day of operation of an RTGS system is unusual.

In the first five days, the transaction value throughput of the UNIS system averaged 70% of the total value that was settled at the Bank of Uganda. The system has also registered a 100% availability rate since its implementation on 21st February 2005.

We have also undertaken a number of initiatives to develop and modernize the value (retail) payment systems. In May 2002, Bank of Uganda, working closely with Uganda Bankers' Association, implemented the **Electronic Cheque Clearing system**. The electronic cheque clearing project automated cheque clearing and also strengthened risk management through the implementation of a National Cheque Standard. We currently have a 3-day cheque clearing cycle in Kampala and a 7-day clearing cycle for upcountry areas. However, Bank of Uganda is working together with UBA to develop a cost-effective method of implementing a uniform 3-day clearing cycle for the whole country.

I am sure that most of you will recall that in August 2003, Bank of Uganda implemented another retail electronic payment system for relatively low value transactions called the **Electronic Fund Transfer (EFT) System**. In the EFT system, bank customers can instruct their bankers to transfer funds from their accounts to named payees in other banks. This system is especially convenient for payment of periodically recurring utility bills like bills for electricity, water and telephone services. While the utility company gets its money on time and as a result, minimizes debt collection expenses, the customer does not suffer the inconvenience of being disconnected when the customer has money in a specified bank account.

The EFT system can also be used to overcome the current inconvenient system of paying university dues or school fees. Parents or guardians should authorize both their bankers and schools to transfer fees from their accounts to school, university or tertiary institution accounts. For this system to succeed, utility companies, educational institutions and banks must support Bank of Uganda in promoting and popularizing the use of the EFT system.

The National Electronic SWITCH:

Another recent development in the payment system is the ongoing implementation of an electronic SWITCH that will enable banks to share their Automated Teller Machines (ATMs) with other banks in the industry. The switch will be another facility which can facilitate customer payments for utilities (i.e. electricity, water and telephone services), or loading of airtime on mobile phones, and payment for purchases using debit cards, which is technically referred to as **Electronic Funds Transfer at Point of Sale (EFTPOS).** Bank of Uganda has already given its **No Objection** to Bankom, a private company, to set up and operate the electronic switch. We expect that in the not-too-distant future, customers of banks which are connected to the electronic switch will be able to access ATM and related services at any ATM of any bank that is a member of the electronic switch.

We also expect the implementation of the switch infrastructure to significantly increase the use of payment cards in the country. All Banks are obliged to use the switch so as to enhance the use of cards on the POS as Debit Cards. In this regard, Bankom must work closely with supermarkets, petrol stations and other outlets to install point of sale machines throughout the country.

At this point, in order to help those who are tempted to doze off, I must quote Ogden Nash;

> *"Most bankers dwell in marble halls which they get to dwell in because they encourage deposits and discourage withdrawals. And particularly because they observe one rule which woe betides the banker who fails to heed it. Which is that you must never lend money to anybody unless they don't need it".*

Micro-Finance Sector:

I will now say something about the tremendous developments taking place in the Micro-finance sub-sector which developments seem to be unrecognized by observers of the financial sector. Overall, the country has about 500 microfinance institutions operating either as community based organizations or NGOs, virtually covering the whole country. In the year 2003, Parliament passed the Micro-finance Deposit-taking Institutions Act, 2003 (MDI Act, 2003). The MDI Act regulates only those micro-finance institutions that take deposits from the public essentially because there is a public interest in protecting depositors' money and those micro-finance institutions which do not take deposits from the public can be well governed by the laws under which they have been licensed to operate. The implementing regulations of the MDI Act 2003 were gazetted in 2004. During the year, Bank Of Uganda licensed M/S Finca Uganda Ltd (MDI) as the first micro-finance institution to be supervised by the Central Bank under the Act. I know that there are several other applications being processed in the Bank of Uganda and I want to encourage many other operators to study the benefits to be derived from taking deposits and to apply for licenses. The major challenges facing this sub-sector are bad corporate governance and limited outreach.

The Financial Institutions Act, 2004:

The banking sector is strong and is poised to remain so because the regulatory framework governing financial institutions has been further strengthened. The Financial Institutions Act, 2004 (FIA, 2004) was enacted and became effective early 2004. The implementing regulations in respect of FIA 2004 have already been approved by the Minister of Finance, Planning and Economic Development and they will soon be gazetted. The new law, coupled with strengthening of Bank Supervision, have enhanced capacity for supervision and strict prudential regulation of financial institutions. The FIA, 2004 strengthened the regulatory framework of the financial sector by addressing a number of issues including the licensing of financial institutions, the ownership and control of financial institutions, as well as corporate governance, transparency and disclosure requirements for financial institutions. The regulatory framework has tightened the prudential requirements for insider transactions, credit concentration and mandatory corrective actions to be taken by the Central Bank on distressed banks and other financial institutions. From this year, there will be no forebearance for recalcitrant or renegade financial institutions.

Credit Reference Bureau:

A lot of consultations have been undertaken to reach agreement on the establishment of a Credit Reference Bureau (CRB) in Uganda. I will not dwell on the obvious importance of the CRB to the financial system but only to state that the success of the CRB will require the co-operation of all financial institutions.

Anti-Money Laundering Initiatives:

Significant progress has also been made in providing a legal framework for dealing effectively with money laundering. A draft Anti-Money Laundering law has already been approved by Cabinet and is ready to be tabled in Parliament soon. The efforts to enact this Anti-Money Laundering law are geared towards preventing the misuse of the financial system in Uganda for purposes of international money-laundering and related economic crimes or for facilitating the financing of terrorism.

Bank Charges:

In view of the fact that the level of Banks' charges is of topical interest in the Press, I would like to say something on the subject. There has been public outcry about high bank charges especially with regard to customer's deposits and withdrawals. Prohibitive bank charges for deposits and withdrawals can potentially discourage the development of a saving culture especially for the medium and small income earners and small savers. I am aware that the problem of bank charges and more importantly the problem of high interest rates is partly a result of structural problems in the industry, as well as a result of the efforts of the Bank of Uganda to sterilize the impact of domestic liquidity of the donor financed inflows which help the government to finance the fiscal deficit but as the authorities take action to reign in the deficit, I fully expect banks to reduce bank charges and lending interest rates. But I also know that there are banks whose regime for charges on their facilities are way above those warranted by prevailing circumstances. Several months ago, I wrote to these banks. While I am committed to a freely market determined regime of bank charges and interest rates, I must make it clear that the Bank of Uganda possesses powers, not least through the annual licensing system, to act on banks which behave like rogue elephants abusing the commons.

Ladies and gentlemen, I wish to thank you all for all your efforts in financial innovation which has contributed to the tremendous achievements recorded within the financial sector. The available statistics show a vibrant financial sector with continuous growth in total assets, deposits and loans, and a significant reduction in the ratio of non-performing loans. All financial institutions are fully compliant with the statutory requirements in relation to capital adequacy, asset quality and liquidity on sustainable basis. I congratulate you all upon the registered achievements.

I want to conclude my speech with the story of a Chief Executive whom I would not like you to emulate.

> *The Chairman of a leading travel agency dies and finds himself sitting alone on a cloud. Along comes an angel and says "Hello, we're having trouble deciding where you should go, whether it should be heaven or hell. So we've decided you can choose for yourself from these brochures The angel gives the man some brochures containing pictures and descriptions of both places. Heaven looks very nice and peaceful with lots of lovely scenery and people sitting around reading, singing or listening to music. Hell looks a lot more lively. Scantly clad girls are frolicking in swimming pools, there are pictures of tables full of sumptuous food, there is dancing, drinking and generally 'a good time' feel. It doesn't take long for the chairman to decide he'd rather go to hell and with that he is whisked away.*
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> *A month goes by and the angel happens to be passing hell's gateway when he sees the chairman chained to a rock with a pair of bellows in his hand, frantically keeping the flames of hell burning. He spots the angel and says bitterly "This is*

nothing like I thought it was going to be!" "All well" says the angel, "You, of all people should know better than to believe all it says on the brochures".

I thank you once again for inviting me and for listening to me.