Louis Kasekende: Uganda's financial sector at 50 – achievements, challenges and expectations for the future

Speech by Dr Louis Kasekende, Deputy Governor of the Bank of Uganda, at the Uganda Institute of Banking and Financial Services Annual Dinner, Kampala, 1 March 2013.

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Chief Executive Officer, Uganda Institute of Banking & Financial Services

Chief Executives of Commercial Banks

Invited Guests

Ladies & Gentlemen

I would like to begin by thanking the Uganda Institute of Banking and Financial Services for graciously inviting me to speak at this occasion, where we will celebrate 50 years of achievements by the banking and financial services industry in Uganda and look ahead to the challenges that the industry will confront in the future. I also want to commend the Institute for the excellent work it is doing, especially through professional training of staff; training which is critical to helping the industry meet the exacting demands of a modern economy in which technology and markets are evolving at a rapid pace.

In these remarks I would like to highlight the most notable achievements of the banking industry since the start of the millennium and then go on to identify what I believe are some of the most pertinent challenges that the industry must face in the years ahead. The banking industry in Uganda can take pride in four major achievements since the start of this millennium; achievements which have brought important benefits for the wider economy and the Ugandan public.

The first achievement I want to highlight is the dramatic increase in the intermediation of funds; the extent to which banks convert the deposits that they mobilise into loans to the corporate and household sectors. In the 1990s, Uganda was a very low intermediation banking system. At the end of the year 2000, commercial bank credit to the private sector was only six percent of GDP and banks only lent out 54 percent of their deposit base to the private sector. By the end of 2012, 80 percent of the banks' deposit base had been lent out to the private sector and private sector credit as a share of GDP had risen to 15 percent. In the twelve years since the end of 2000, bank lending to the private sector has risen five fold in real terms.

The second impressive feature of the performance of the banking industry in recent years is the expansion of the branch network. In the year 2000, there were 129 bank branches in Uganda. At the end of last year this had risen to 495, a four fold increase. In the last five years, Uganda has seen an average of 60 new branches a year opened for business. Furthermore, banks are spreading their operations around the country; there are now 270 bank branches outside of Kampala. The expansion of the branch network also reflects greater competitive pressures within the banking market, with banks aiming to attract new customers by expanding into areas where they did not previously have a presence.

Thirdly, the phenomenal growth of mobile money services has brought access to basic payment services within reach of millions of Ugandans who do not have ready access to bank branches or own a bank account. There are currently 8.9 million registered mobile money customers in Uganda, more than one quarter of the entire population. Mobile money transactions totalled Shs 11.7 trillion in 2012, a 211 percent increase over the total in 2011. Furthermore, mobile banking offers enormous potential for further expansion, especially by broadening the type of service which can be provided to customers.

Fourthly, the Ugandan banking system – and I am here referring to the system as a whole rather than individual banks – has remained in a very sound financial state despite all of the challenges it has faced in recent years emanating from the impact of the global financial crisis, the rise in domestic interest rates and the slowdown in economic growth. The basic indicators with which we measure financial soundness are all positive. The total capital of the banking system is a very healthy 22 percent of its risk weighted assets and the quality of bank capital is very good with core capital comprising 86 percent of the total regulatory capital of Ugandan banks. The banking system is profitable, with an annual return on assets of around four percent. Non performing loans were only just over four percent of total loans at the end of 2012; hence the rapid increase in intermediation that I have just mentioned has not been brought about at the expense of loan quality. These ratios justify a high degree of public confidence in the safety and stability of the financial system and are also testimony to the prudent risk management of commercial banks in Uganda.

The banks in Uganda can take pride in these important achievements and the contribution they have made to the development of the economy since the 1990s. The growth in the intermediation of funds, the expansion of the branch network and the development of new products has enabled the financial sector to generate average real growth of 10 percent per annum since 1999/2000; it has been one of the fastest growing sectors of the economy in this period. However, I think we must also be very honest in recognising that there are some aspects of the performance of the banking industry which arouse concern among the public and policymakers in this country.

The first issue of concern which I want to discuss is that of interest rate spreads and margins, which are very high in Uganda. The average net interest margin (which is calculated as total interest income minus total interest expense, divided by total earning assets) of the Ugandan banking industry in 2012 was 12.7 percent. This is much higher than the average for sub-Saharan Africa which was 7.5 percent, which is in itself much higher than in most other regions of the world. Equally worryingly, the progress which had been made by banks in the mid 2000s in reducing their interest margins has been reversed in the last two years. Net interest margins fell from 14 percent in 2005 to just over 10 percent during 2008–2010, but they have subsequently crept back up by more than two percentage points.

The reasons for the very high net interest margins in Uganda are complex. I do not dispute that the high costs of doing business in Uganda are a major contributor to this problem. Nevertheless, I don’t think that this is the only reason why margins are so high in Uganda. The rise of two percentage points in net interest margins which occurred in the last two years was accompanied by an increase of about 10 percentage points in the share of profits before tax in banks’ net interest income. In other words, bank profits have risen faster than their costs in the last two years and it is higher profits which account for most of the increase in net interest margins which took place in 2011 and 2012. Bank operating costs as a percent of their total assets have actually fallen slightly since 2009, from around 5 percent to 4.4 percent in 2012.

Looking ahead, I believe that it is imperative that the banking industry makes serious efforts to reduce its interest rate spreads, thereby allowing lending rates to be lowered and, eventually, more remunerative deposit rates to be offered to savers. The Bank of Uganda intends to use its monetary policy to target a core inflation rate of 5 percent over the medium term, and we are confident that this target can be delivered. This implies that, with nominal commercial bank lending rates currently averaging nearly 25 percent, borrowers are paying real lending rates which average almost 20 percent. I find it inconceivable that average real lending rates of this magnitude are sustainable over the long term, because most private sector businesses will not generate sufficiently high real returns to enable them to service their debt. Therefore, if we want to see continued growth of bank lending to creditworthy borrowers, it is unavoidable that bank lending rates and, therefore, interest rate spreads, must be reduced substantially. If banks are to narrow their net interest margins without reducing their profits, they must become more efficient and control their operating costs, perhaps by exploiting economies of scale and scope.

The second area where I think there is some justifiable concern about the performance of banks is the sectoral composition and characteristics of bank lending. I have already highlighted the very impressive growth in aggregate bank lending since the start of the millennium. However, most of this lending is extended to the non traded goods sectors, especially trade, construction and telecommunications, and to the household sector. The traded goods sectors of the economy, such as agriculture and manufacturing, receive only 21 percent of total bank credit to the private sector. The low share of lending extended to the traded goods sectors is a concern because it is the growth and diversification of these sectors which are the principal drivers of technological upgrading and thus economic development over the long term. A developing economy can often generate rapid spurts of economic growth over the short term based on investment in services and construction, but long term growth and structural transformation is almost always led by the export sectors.

The Ugandan economy is not attracting anywhere near enough private investment in the traded goods sectors in which it has a comparative advantage on world markets and which could, therefore, drive export led growth; sectors such as commercial agriculture, agro-processing, light industry and tourism. The lack of private investment in these sectors is also reflected in the relative paucity of bank financing for them. I am not trying to claim that a shortage of bank lending is the only binding constraint to higher investment in these sectors, because there are clearly many other serious constraints; weak business and technological skills, the high costs of doing business, poor transport logistics and infrastructure, for example. However, the creation of a customs union and a common market in the East African Community will expand market opportunities for Ugandan traded goods industries and thus should enhance incentives for private investment in these industries.

If we are to begin to build dynamic traded goods industries in Uganda we have to find ways of channelling more finance to these industries, both for capital investment and working capital. I appreciate that lending to these industries, especially when it involves non traditional exports, is often much more risky than lending to the services and construction sectors, but that should not be an insurmountable obstacle if banks can upgrade the skills they need to evaluate borrowers and develop innovative products to help mitigate the risks. The need to channel more credit to the traded goods sectors also underlines the urgency of reducing real lending rates in Uganda. Industries which sell their products and services on competitive global markets cannot normally expect to earn very high rates of return to capital; this inevitably limits their capacity to borrow at real lending rates in the region of 20 percent, as is currently the case in Uganda.

I would also like to signal a note of caution about the rapid build up of foreign currency lending by the banks, which stands in sharp contrast to the stagnation of Shilling denominated lending. The ratio of foreign currency denominated loans to total outstanding loans has risen sharply since mid 2011, from 25 percent to the current level of 38 percent. Most of this increase is not attributable to the depreciation of the exchange rate which has occurred in the last few months because the dollar value of these loans has itself risen by 27 percent over the last 12 months and by over 60 percent in the last 18 months. I am not worried about the foreign exchange market risk carried by the banks, because their net foreign exchange exposure is very small, but I am concerned about the liability dollarization of the real sector, which could translate into future credit risk if real exchange rate depreciation raises its real debt burden.

The sector which has experienced the fastest growth in foreign exchange borrowing over the last two years is construction, mortgages and real estate; this sector now accounts for a quarter of all foreign exchange borrowing from the banking system. It is a sector where the underlying demand for the services provided is derived from domestic residents rather than export markets and hence the ability to generate revenues to pay for these services must be affected by changes in the real exchange rate. Similar considerations are relevant to foreign exchange borrowing by other sectors, such as most of the trade sector and telecommunications which account for a further quarter of foreign exchange borrowing. I hope that banks will be very careful about extending foreign currency loans to borrowers who do not have a strong foreign currency revenue stream from which to service their debt and which might, therefore, be vulnerable to adverse shifts in the real exchange rate.

To conclude I would like us to take pride in the achievements of the banking industry over the last decade; it has become one of the most dynamic sectors of our economy. But I also want you to think about how the industry needs to evolve in the years ahead so that it can best meet the needs of its customers and the Ugandan economy.

Thank you for listening.