David G Opiokello: The aftermath of the financial crisis and the way forward

Closing remarks by Mr David G Opiokello, Deputy Governor of the Bank of Uganda, at the 3rd Annual Bankers' Dinner, Kampala, 7 May 2010.

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Introduction

Ladies and gentlemen,

The inclusion of the word "aftermath" in the title of this talk implies that the global financial crisis which erupted in 2008 is now over. That is probably true in respect of the most acute manifestation of the crisis – the systemic failures in key financial markets around the globe – but the repercussions of the financial crisis will be felt for many years to come; and this applies to countries, such as Uganda, which were relatively less badly affected by it as well as to countries where the impact was very severe. In this talk, I want to sketch out what I think are the key lessons of the global financial crisis for Uganda and how this will shape the development of the banking sector in Uganda in the medium to long term. In doing so I must, inevitably, be selective: there is not sufficient time to even begin to touch on all of the potential consequences and lessons of the financial crisis, so instead I will focus on what I believe are the issues which are most germane for the Ugandan banking sector.

The Ugandan banking system and the impact of the financial crisis

The Uganda banking system, which still dominates the financial sector in Uganda, grew rapidly in the years preceding the outbreak of the global financial crisis. This growth was manifested in financial deepening, measured by banking system liabilities as a share of GDP, and even more so in the growth of bank loans to the private sector. The latter doubled as a share of GDP between 2000 and 2008 and loans also increased as a share of commercial banks' asset portfolios. These were very positive developments for the Ugandan economy; reflecting the growing role of banks in the intermediation of funds from creditors to borrowers.

For a variety of reasons the Ugandan banking system was not affected severely by the global financial crisis. Although it has links with global financial markets, the nature of these links helped to insulate it from contagion emanating from the meltdown in financial markets elsewhere in the world; a point I will return to later.

Secondly, although the Ugandan economy was hit by a large external shock in the 2008/09 fiscal year as a result of the global economic crisis, it was able to ride out this shock without suffering either a balance of payments crisis or a recession. I think that this can be attributed, in large measure, to the macroeconomic policy framework which we have put in place in Uganda, but that is not an issue I have time to dwell on this evening. From the standpoint of the banking system, the resilience of the economy in the face of the external shock was important because it meant that bank borrowers have not been driven into distress, and hence there has not been a substantial rise in non performing loans.

Thirdly, the Ugandan banking system, despite its buoyant growth in the 2000s, is well capitalised, has much lower leverage ratios than banks in developed countries and has stronger liquidity. As a result, the balance sheets of banks in Uganda are much less vulnerable to negative shocks to the quality of their assets and to their liquidity than were many banks in the developed countries.

Nevertheless, although we can take some pride in our banking system having avoided the fate of its counterparts in many other countries in the last two years, we cannot afford to be complacent. In the years ahead, our financial system is almost certain to become larger, more complex and more sophisticated and more globally integrated, an evolution which itself will probably be a source of greater vulnerability to financial instability. If we are to mitigate this vulnerability, we have to learn the lessons of the global financial crisis and understand how these might be relevant to Uganda in the years ahead. I turn to this issue next.

Lessons of the global crisis for financial sector policy

The global financial crisis is having a profound impact on strategy and policy towards the financial sector across the globe, in developed economies and in the emerging markets and developing economies. It has prompted a radical re-assessment of how policymakers see the balance of costs and benefits of financial markets. Prior to the crisis there was an almost common belief among academics, policymakers and financial regulators, at least in western countries, that the deepening of all financial markets and financial innovation of all types was beneficially to the economy, because greater opportunities for economic agents to trade in financial markets would automatically raise welfare, and would also promote more stable financial markets. These beliefs look much less tenable today, if not absurdly Panglossian. In particular it is evident that some financial innovations, such as the securitisation of assets, which it was claimed would reduce financial fragility by allowing risk to be allocated to those best able to bear it, did exactly the opposite and created systemic risk on a mammoth scale. The financial crisis has also thrown into question whether some of the activities of financial institutions which enjoyed explosive growth in the 2000s and generated a major source of their profits, such as proprietary trading in financial assets, provide any significant social benefits at all.

Efforts to reform financial regulation at the global level – spearheaded by the G20 and the Basel Committee on Financial Supervision – are already underway. There is a widespread recognition that the financial crisis exposed very serious weaknesses in the framework for financial regulation built up over the last two decades in the western world. As such, regulatory reforms will undoubtedly be implemented although the precise nature of these reforms is still the subject of much debate and dispute. It is very likely that, at the global level, there will be moves to strengthen the capital adequacy framework for banks (the Basel Accords), to introduce stronger liquidity requirements and probably to impose a leverage ratio on banks. There will also be moves to introduce macro-prudential regulations which are intended to dampen the pro-cyclical nature of bank lending; for example through some form of countercyclical capital buffers and forward looking provisioning, although how this will operate in practise is still being worked out. Much more controversial are proposals to restrict either the permissible activities of banks – which are intended to separate commercial banking from investment banking – and to limit the size of banks to prevent them from becoming "too big to fail".

Regulatory reforms in Uganda

For the rest of this talk I want to concentrate on what I believe will be the most pertinent issues for bank regulation in Uganda. Reform in Uganda will be influenced by global reform efforts, although not all of the specific proposals agreed at the global level will necessarily be relevant for Uganda. Regulatory reform in Uganda must also take account of the requirements of the common market in East Africa. I want to focus on four aspects of the regulatory regime that I think are the most critical in the medium term: capital requirements, the scope of permissible bank activities, how to address challenges arising from the global integration of finance and regional harmonisation of regulations.

Capital requirements

Capital plays a double role in banking. It provides incentives for bank owners to ensure sound management of their bank and it provides a buffer to protect depositors and other bank creditors against losses. Capital requirements in Uganda comprise two separate components; a minimum paid up capital requirement and an ongoing capital adequacy requirement which relates a regulatory definition of capital to risk weighted assets.

At the global level, concerns have focussed on loopholes in the capital adequacy requirements: banks in western countries were able to "game the system" to reduce the amount of capital that they were required to hold, thereby driving up their leverage. We have not faced similar problems in Uganda and I don't think that radical changes in capital adequacy requirements are needed yet. We already impose a higher capital adequacy requirement – 12 percent of risk weighted assets – than the minimum of 8 percent stipulated in the Basel Accord and most banks in Uganda currently operate with much more capital than the statutory minimum. We do, however, need to make two revisions to the capital adequacy requirements to cover risks which were not previously considered pertinent but which have become more so. First, we will shortly introduce a capital charge for market risk, which is necessary for full compliance with the Basel I Accord. Secondly, we will eventually introduce a capital charge for operational risk, based on one of the methodologies in the Basel II Accord.

We require more a radical change to the minimum paid capital requirement for banks. The current statutory minimum of Shs 4 billion, which was set six years ago, is far too low. It does not ensure that new entrants to the banking industry have sufficient capital to support their operations before they reach a scale where they can begin to generate profits. It has also fallen way below the minimum statutory levels imposed by our neighbours in East Africa and elsewhere in Africa.

Although the banking system as a whole in Uganda is currently well capitalised, the evolution of the banking system over the long term is likely to intensify the risks to which banks are exposed. Hence I believe that the changes I have just described will help to ensure that banks are better able to withstand shocks to their balance sheets. I think that the higher minimum paid up capital requirement will also stimulate a degree of consolidation in the banking industry in Uganda, with fewer but larger commercial banks. I will return to this issue when I discuss the implications of the East African common market.

The scope of allowable banking activities

The question of whether commercial banks should be allowed to engage in "non bank" activities, and if so, what specific activities should be permitted, poses acute dilemmas for regulatory policy. In developing countries, the objective of promoting a diversification of what are often very narrow financial markets with very few non bank financial institutions suggests that a liberal view of what commercial banks are allowed to do is appropriate from the standpoint of financial market development. On the other hand, prudential objectives often favour restricting bank activities to traditional commercial banking – taking deposits and making loans – where the risks are at least relatively well understood.

The Ugandan banking legislation – the Financial Institutions Act – generally restricts banks to the traditional bank activities. For example, the Financial Institutions Act does not allow banks to engage in the insurance business nor does it allow banks to underwrite shares or act as a securities broker or to deal in securities on their own account, other than for Government or Bank of Uganda securities.

I believe that there is a strong case for allowing banks to offer to their customers financial products for which there is a clear market demand from the household and the corporate sectors, provided that this does not undermine prudential standards and, critically, that the risks of these activities can be understood and managed. As such the Bank of Uganda has

recommended to the Government that the Financial Institutions Act should be amended to allow banks to provide "bancassurance" and Islamic financial products, and if these amendments are enacted by Parliament the Bank will issue prudential regulations applicable to these products. I hope that this will promote the growth of the insurance market and the market for Islamic financial products, which should benefit bank customers in the real sectors of the economy. Permitting banks in Uganda to offer these products will also align the Ugandan banking laws with those in other African countries which have already moved, or are moving, in a similar direction.

We should be much more cautious about liberalising our banking legislation to allow commercial banks to engage in proprietary securities trading or brokerage activities. As the global financial crisis has demonstrated, proprietary trading carries potentially large risks for banks; risks both to the value of their assets and to their liquidity. Furthermore, a banking system which is heavily engaged in proprietary trading may be more vulnerable to systemic risk, because of the pro-cyclical impact of marking securities to market and because of the heightened liquidity risks created by proprietary trading. Moreover, as was made clear by the global financial crisis, it is very difficult to quantify market and liquidity risk of this nature, which is partly endogenous to the financial system; financial institutions tend to underestimate these risks and often have powerful incentives to do so if trading activities are very profitable. It is also less evident that all of the proprietary trading activities of financial institutions really provide significant economic benefits for the rest of society.

Global financial integration

Global financial integration – the integration of the Ugandan financial system with that of the rest of the world – engenders difficult challenges for regulators and policymakers. For the last two decades Uganda has adopted a broadly open approach to the global integration of the financial system. We do not restrict the entry of foreign owned banks provided that they comply with the licensing requirements and we do not impose restrictions on transactions on the capital account of the balance of payments. In general I think that these policies have served Uganda well, helping to promote the development of the banking sector and attract foreign investment. I do not think that we should reverse these policies, but some reforms are needed, for the reasons that I will explain.

Uganda is now classified as a "frontier market". The term frontier market denotes a nascent emerging market, and is applied to low income countries which are experiencing rapid private sector led growth and whose financial markets are beginning to attract investment from foreign institutional investors. This is a positive development; it shows that we are making progress towards middle income and emerging market economy status. However, development involves risks. A prominent characteristic of emerging markets is their vulnerability to capital account crises; what are sometimes referred to as "sudden stops". There are many examples of capital account crisis in emerging markets in recent history, in Latin America, East Asia and most recently in the former communist countries.

As I mentioned earlier, Ugandan banks avoided contagion from the global financial crisis. This was not because they have no links with financial markets abroad; rather it was because of the nature of these links. Ugandan banks are net creditors with financial institutions abroad. In addition, the assets which Ugandan banks hold abroad are mostly low risk and highly liquid. As a consequence Uganda did not suffer losses on their external asset portfolios and they were not vulnerable to a loss of liquidity arising from foreign creditors withdrawing access to credit: i.e. a sudden stop.

The nature of the links between Ugandan banks and financial markets abroad will probably change over the medium to long term as the Ugandan economy progressively acquires the characteristics of an emerging market economy. I would expect that Uganda banks will eventually become net debtors to foreign financial institutions because economic growth in Uganda should create more investment opportunities which provide higher rates of return,

even after adjusting for risk, than the cost of borrowing abroad. Attracting more capital into Uganda through the banking system provides major benefits, because it should allow a higher rate of investment than would otherwise be possible, but it also carries risks, as the experience of many emerging markets has demonstrated. It makes both the balance of payments and the banking system vulnerable to a "sudden stop" in short term private capital flows, which could be triggered by contagion from events which have nothing to do with Uganda. In addition the volatility of short term private capital flows can make the exchange rate less stable. How should we mitigate these risks?

There are two areas where reforms could be useful. In terms of bank supervision we need to provide stronger safeguards against banks intermediating foreign currency denominated resources to domestic borrowers whose balance sheets, and thus their capacity to service their loans, would be damaged by exchange rate depreciation. This has been a serious problem in emerging markets and is one of the main reasons why capital account crises have often led to steep contractions in output. We also need to ensure that banks maintain sufficient liquidity in foreign exchange to meet short term commitments in the event that access to foreign borrowing dries up.

I believe that we should also consider whether to discourage purely short term portfolio capital flows through some form of tax, although I appreciate that there are serious practical obstacles to doing this without creating incentives for agents to seek ways of evading the tax. The main reason why I think that this is worth considering is that purely short term portfolio flows, which are mainly intermediated in the domestic money markets, may exacerbate short term volatility in the exchange rate while they do not provide any great benefits to the economy: they are far too short term to provide resources for funding capital investment. All of the five countries of the East African Community are committed to the eventual adoption of a monetary union with a single currency. As we move into the transition towards monetary union, exchange rate management will become an increasingly important macroeconomic objective for all of the EAC partner states. As anyone familiar with the transition to the single currency in the European Union in the 1990s will recall, short term capital flows created major difficulties for the alignment of currencies which is a prerequisite for a monetary union.

Regional integration

Finally I want to discuss the implications of East African economic integration for the banking industry and for bank regulation. The five partner states of the EAC are due to sign the protocol for the East African common market this year. The common market should remove all restrictions on trade in goods, services, capital and labour within the EAC; hence it has profound implications for financial services. In principle the common market should eventually allow banks headquartered in any one partner state the "right of establishment" in each of the other partner states and allow citizens of each partner state to purchase financial services from banks in the other partner states. Precisely how the "right of establishment" will operate with respect to banking has yet to be decided. For the banking industry, a key question is whether all banks, including those headquartered within the EAC, should only be allowed to take deposits in any individual partner state if they operate as a fully capitalised subsidiary in that state, rather than merely as a branch. I think that the recent experience in the European single market should caution us against permitting bank branching across borders.

The creation of a common market should lead to more efficient financial services. I mentioned earlier that I believe that some consolidation in the Ugandan banking sector will be necessary and beneficial. In particular larger banks will be better placed to take advantage of the expansion in the size of the market created by the common market and to reap economies of scale which can bring down the very high operating costs as a percentage of assets which afflict banks in Uganda. Lower operating costs will in turn help to

reduce intermediation spreads which will benefit bank customers in the real sectors of the economy.

To create an efficient common market in banking services it will be necessary to harmonise many aspects of bank regulations across all five partner states. This is necessary to create a level playing field for banks and to prevent regulatory arbitrage whereby banks aim to operate from the jurisdiction within the EAC with the weakest regulations. I mentioned earlier that the Bank of Uganda will advise the Minister of Finance to raise the minimum paid up capital requirement for banks. The increase in part is motivated by the need to align our capital requirements with those of our partners in the EAC. Kenya will raise its minimum capital requirement to Ksh 1 billion, which is nearly $13 million, by 2012. Other aspects of bank regulations will also need to be harmonised, including permissible activities, restrictions on loan concentrations and liquidity requirements.

Conclusion

I have covered a lot of ground in this talk so I shall refrain from detaining you for much longer. I would like to finish with the following conclusions. I am convinced that the banking industry faces exciting challenges in the years ahead. The prospects of sustained economic growth coupled with East African economic integration will offer banks huge opportunities for expanding and diversifying their business. But over the medium to long term the banking industry, and hence the broader economy, will face greater risks as it becomes larger, more sophisticated and more integrated with global financial markets. Banks' risk management will have to be continuously upgraded to tackle the evolving nature of risks that they face, as will bank regulation and bank supervision.

Thank you very much for listening.