BANK OF UGANDA

Speech by

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Chief Guest

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Good evening ladies and gentlemen.

Let me begin by commending the Institute of Banking and Financial Services for the excellent work it is doing, especially in providing professional training for staff of the financial services industry. The Institute is making a truly invaluable contribution to the success of the industry in Uganda.

As we approach the end of the year, I would like to take this opportunity to reflect on the last 12 months from the standpoint of the banking industry and try to draw some lessons. We cannot deny that it has been a difficult year for the industry, with very low asset growth, a sharp deterioration in asset quality and a decline in returns on equity.

The key challenge has been the rise in nonperforming loans (NPLs), from 3.8 percent of the total loans of commercial banks in September 2015 to 7.7 percent in September 2016. Over the year to September 2016, the commercial banks had to make provisions of Shs 345 billion for NPLs, which is double the amount set aside in the previous 12 months. These provisions squeezed profits, with average after tax returns on equity falling to 14.9 percent in the 12 months to September 2016 compared to 17.1 percent in the previous 12 months. The squeeze on bank profitability would have been much worse were it not for the fact that banks widened their net interest margins. The high interest rates which prevailed over the course of most of the last 12 months helped banks to recoup some of the losses they suffered as a result of bad debts.

On a more positive note, the latest quarterly data indicates that we may have passed the peak of NPLs in the banking system. In absolute terms, the value of NPLs fell by 6 percent between July and September of this year, although it is still too early to be very confident that NPLs are really on a downward trend.

The deterioration in loan quality has been one of the major factors impeding the growth in lending to the private sector. Over the 12 months to September

2016, the value of loan applications rose, albeit at a relatively modest 7 percent compared to the previous 12 months, whereas the value of loans actually approved by banks fell marginally, by 2 percent. This suggests that the main constraint to loan growth has been on the supply side of the credit market rather than on the demand side, with banks turning down loan applications because of concerns about borrower creditworthiness or the realisable value of loan collateral, given the saturated state of the property market.

As you are all aware, the Bank of Uganda had to intervene in Crane Bank and take it into statutory management in November. The cause of Crane Bank's distress was non performing loans, which had risen to more than 20 percent of its total loan portfolio and which left it significantly under capitalised. Because it is a systemically important bank, we intend to resolve Crane Bank in a manner which preserves its core functions and services to customers.

Fortunately, all of the other commercial banks are meeting their capital adequacy requirements. One of the most important strengths of our banking system, and the key to its resilience, is the strong capital buffers which banks hold. In aggregate, the banking system holds total capital equivalent to 22.5 percent of its risk weighted assets, which affords it with large buffers to absorb adverse shocks. This conclusion is also borne out by the macro stress tests which the BoU carries out on a regular basis as part of its financial stability monitoring and which show that it is the large capital buffers held by banks which is the main source of their resilience to withstand adverse shocks.

What are the causes of the rise in NPLs in the banking system? There are macroeconomic, sectoral and a variety of idiosyncratic factors which have contributed to the problems. On the macroeconomic front, the rise in interest rates in 2015, which was necessitated by inflationary pressures, combined with exchange rate volatility increased the stress on borrowers. At the sectoral level, there have been problems in the commercial real estate sector, where heavy investment in recent years has led to oversupply in the market with the result that occupancy rates have fallen and many owners have not been able to generate sufficient income to service their loans. Mounting government arrears to suppliers and contractors has also contributed to NPLs while borrowers with business in South Sudan have suffered losses because of the acute political and economic problems in that country. The idiosyncratic problems mainly pertain to failures among borrowers themselves, such as the diversion of borrowed funds from their intended uses. These factors are not mutually exclusive. For example, a poorly managed business will find it much more difficult to survive a sectoral or macroeconomic shock than a well managed business.

What lessons for the future can we draw from the difficulties we have faced over the last year? I would like to highlight three areas where we can strengthen banking sector performance and resilience.

First, banks need to strengthen their credit management to mitigate credit risks. One crucial area which needs to be addressed is that of currency mismatches. Foreign currency loans account for 43 percent of total bank loans, but the majority of borrowers operate businesses in the non traded goods sectors of the economy. Even if borrowers of foreign currency loans which operate in non traded sectors price their output in dollars, as many owners of commercial property do, they are still vulnerable to shifts in the real exchange rate, because their customers do not earn dollars. Exchange rate depreciation raises the real value of dollar denominated loan repayments but it does not enhance the capacity of non traded goods businesses to earn more income. Banks should restrict foreign exchange lending to companies which sell their output on the global market rather than the domestic economy, such as exporters. In general banks must be careful in evaluating the capacity of the prospective borrower to continue servicing a loan in the event of plausible shocks to revenue streams or debt servicing costs.

Secondly, one of the reasons why lending rates of interest remain high is that banks incur heavy operating costs Annual operating costs as a percent of average bank assets are as still as high, at more than 7 percent, than they were 10 years ago. As a percentage of their earning assets, banks' operating costs average nearly 11percent. These costs must be covered from the interest rate spread and non interest income; hence it is not surprising that interest rate spreads are high in Uganda. Over the long term, we need to lower lending rates in Uganda in a sustainable manner, to support the growth of private sector business, but this will only be possible if banks' operating costs can be reduced.

Thirdly, as I noted above, it is the large capital buffers which banks hold which ensure the stability of our banking system. Average capital adequacy ratios exceed the statutory minimums, by 11.8 and 10.5 percentage points respectively for core and total capital. In line with the Basel III reforms and the agreements reached between the central banks of the East African Community, we are raising the minimum statutory capital adequacy ratios at the end of December 2016, to lock in most of the higher capital that banks currently hold. The minimum core capital requirement will be raised to 10 percent of risk weighted assets and banks will also be required to hold a capital conservation buffer of 2.5 percent of their risk weighted assets. The domestically systemically important banks will also be subject to a capital surcharge. Most of the banks in Uganda already hold sufficient capital to meet the new capital requirements, so they will not have to mobilise additional capital. However, the new capital requirements raise the floor on the amount of capital which banks must hold and so will help to ensure that banks continue to hold very strong capital buffers. Strong capital buffers are the foundation of sound banking and hence I believe that the revisions to the capital adequacy ratios will enhance public confidence in our banking system.

To conclude, ladies and gentlemen, I hope that next year will see a resumption of more robust growth in the banking sector and especially in bank lending to the private sector. With inflationary pressures having eased over the course of 2016, the BoU has reduced the policy interest rate and I hope that banks will now pass on this reduction to their borrowers. Banks also need to strengthen their credit policies and begin to tackle the problem of high operating costs.

Thank you for listening.

Prof. Emmanuel Tumusiime-Mutebile

GOVERNOR