BANK OF UGANDA

Remarks by

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Uganda Bankers' Association

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The Keynote Speaker, Prof. Njuguna-Ndugu, Emeritus Governor of the Central Bank of Kenya,
The Chief Executives and Senior Staff of Banks Present,
The Senior Management of the Uganda Institute of Banking and Financial Services,
Distinguished guests,
Ladies and gentlemen.

Good morning to you all.

Let me begin by commending the Uganda Bankers' Association for organising this inaugural Annual Bankers' Conference. We have a very busy schedule of sessions on a variety of important topics to look forward to today. In my brief remarks I would like to outline what I believe are some of the key challenges for the Ugandan banking industry in the years ahead.

As will become clear, these challenges are in some respects interrelated, as progress in one area will make it easier to make progress in others.

A major challenge for the banking industry; one which is of the greatest importance for the rest of the economy, is how to strengthen bank lending to the private sector.

Bank lending expanded rapidly in the first decade of this century; in real terms the stock of credit expanded four-fold between 2001 and 2011, and this enabled many new borrowers to access credit.

But since 2011 credit growth has slowed and over the last two years, there has been virtually no growth in real terms (after adjusting for inflation).

The main reasons for the stagnation of bank lending lie on the supply side of the credit market. Over the last five years, since the first half of 2012, loan demand, as proxied by the value of loan applications received by banks, has grown robustly, by about 17 per cent per annum in real terms, but the value of loans actually approved by banks has grown much more slowly. Consequently, whereas in the first half of 2012, banks approved loans in value amounting to 70 per cent of the total loan applications that they received, that figure had fallen to 51 per cent in the first four months of 2017.

It is clear that, against a background of rising non-performing loans and difficulties in realising the value of loan collateral in property markets, banks have become much more wary about the creditworthiness of loan applicants and as a result have become more reluctant to extend credit to them.

Unfortunately, the pool of prime borrowers – mainly large, well established companies – is small in Uganda. Hence if they are to expand their loan portfolios in a financially sustainable manner, banks will have to bring into the credit market more small and medium sized enterprises (SMEs).

To do this, banks will need to strengthen their capacities for identifying and evaluating potential new loan customers and ensuring that the characteristics of the loan products on offer are suitable for the types of business undertaken by their customers, especially in aligning loan repayments with the future stream of business revenues. Given that an expansion of banks' loan portfolios will almost inevitably involve banks being exposed to greater credit risk, it is essential that this is accompanied by a strengthening of banks' risk management strategies.

The ability of borrowers to service their loans and, therefore, their creditworthiness, is not independent of the interest rates charged on these loans. The higher are lending rates of interest, the larger is the burden placed on the borrower to service his or her loans.

Ceteris paribus, lower interest rates would, therefore, contribute to enhancing the capacities of borrowers to service their loans out of their business revenue and thereby help to alleviate credit risk. Reducing lending interest rates in a financially sustainable manner is the second major challenge facing the banking industry.

Unfortunately, high lending rates of interest are primarily the result of the high cost structure of banking in Uganda, and lending rates will not fall in a sustainable manner until banks have been able to bring down their operating costs.

The average annual operating costs of Ugandan banks, as percentage of their income earning assets, is currently around 11 per cent, which is very high by international standards.

Large branch networks and the high cost of staff are major contributors to the high operating costs of banks. When the interest costs of deposits and provisions for bad debts are added to operating costs, banks' annual costs as a per cent of their income earning assets rises to almost 18 per cent, which obviously constrains the extent to which average lending rates can fall.

Hence, the third challenge facing the Ugandan banking industry is how to reduce its high operating costs, without compromising service delivery or customers' access to services.

The structural factors, which underlie the high bank lending rates point to the inevitable consequences of any attempt to force banks to reduce their lending rates by legislation, as has happened in Kenya.

If lending rates were capped by legislation at levels below the real cost of lending, taking into account operating costs, provisions, and the costs of funds, banks would make losses on their loan portfolios.

They would respond by curtailing their lending to those borrowers to whom lending involves the highest costs, in the form of high transaction costs for loan evaluation and monitoring, and/or because of higher credit risk premiums. The banks might also attempt to recover some of their losses by increasing the fees and charges levied on their customers.

If lending rates were capped, the borrowers who would suffer the most, in terms of losing access to credit, would be SMEs. This is because SMEs are both more risky and involve higher transaction costs for the banks as a share of the amount that they borrow than prime borrowers.

Given these costs, banks can only extend credit to SMEs in a commercially viable manner if they are free to set lending rates at levels, which can cover the expected costs of lending, including the default risk.

Instead of lending to SMEs, capping lending rates would encourage the banks to concentrate their reduced loan portfolios on their prime borrowers, which already benefit from the lowest lending rates in the economy.

Thus capping lending rates would be highly counterproductive in that it would damage the SME sector by constraining its ability to obtain working capital and finance for investment to expand capacity.
As the SME sector is crucial for the future growth of the economy and the creation of employment, capping lending rates would constitute an act of economic self-harm.

We already have the salutary experience of the 1970s and 1980s to teach us how damaging the control of interest rates can be. In that period, the banking sector shrank dramatically because many types of banking business, including lending to the private sector, were not financially viable. Uganda cannot afford to repeat the mistakes of the past; mistakes, which proved so ruinous to our economy.

I cannot stress strongly enough that it will only be possible to reduce bank lending rates in a financially sustainable manner if banks can lower their operating costs.

Bringing down operating costs will almost certainly entail greater use of innovative technologies, including IT, to deliver banking services.

A major shift towards digital, or electronic banking is already underway worldwide, as we will be discussing in the session on the digital financial revolution later this morning.

The adoption of mobile and online banking, together with smart ATMs, will help banks reduce their costs, although unfortunately that will also mean lower employment in the banking industry.

As they adopt electronic banking technologies, key challenges for banks will be to ensure that these new technologies can deliver the same quality of, and access to, services for their customers as the more traditional technologies and that the risks entailed in electronic banking are fully understood and can be managed effectively.

In particular, banks must ensure that their electronic systems can be safeguarded against cyber-attacks, both to protect the integrity of individual customer's accounts and to prevent threats to the financial safety of the bank itself.

The adoption of electronic banking has implications for bank regulation and supervision, which in Uganda has traditionally focussed on banks' management of credit risk.

In future, operational risks arising from electronic banking are likely to become of greater significance as potential threats to the financial soundness of banks and their ability to command the confidence of their customers. Bank regulators need to strengthen their capacities for monitoring the security of banks' IT systems.

To conclude, I believe that the future of the banking industry in Uganda is bright. In terms of productivity, the adoption of international best practises and its use of modern technology, banking is one of the leading industries in Uganda.

Banking also operates in a macroeconomic and prudential regulatory environment, which provides scope for investment and innovation while, at the same time, safeguarding the interests of depositors and the safety and soundness of the financial system.

Consequently I am confident that banks will be able to meet successfully the challenges that they face, and in doing so, continue to contribute to the development of the Ugandan economy.

Finally I would like to wish you all the best for the rest of this conference.

Thank you for listening to me.