BANK OF UGANDA

Key Note Address by

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Topic: ***Governance in the Financial Sector: Is the Financial Sector Over Regulated?***

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Heads of Regulatory bodies within Uganda's financial sector,
The Principal, Makerere University Business School (MUBS)
Invited Guests,
Ladies and Gentlemen,

Good morning.

I would like to begin by commending the Makerere University Business School for organising this International Leadership Conference and by thanking the Principal of the Business School, Prof. Balunywa, for inviting me to give a keynote address. The theme of my address this morning is financial regulation.
I want to explore the objectives and the economic rationale for regulating the financial sector. I will then address the question of whether the financial sector is over regulated in Uganda.

What is the rationale for regulation of the financial sector?

Throughout the world, in both developed and developing countries, the financial sector is one of the most heavily regulated sectors of the economy. Many types of financial institutions are subject to a raft of regulations, such as capital requirements, restrictions on their business activities and financial disclosure requirements which are not applied to most other types of business.

For the most part, non-financial sector businesses, such as manufacturing, construction or agriculture, are subject to health and safety standards to protect their employees and some minimum product standards to protect their customers. However, apart from that, the governance of their business activities is left to the market and is not subject to regulation by a public agency. Why is the financial sector different?

There are two fundamental reasons why the financial sector is much more highly regulated than other sectors of the economy: leverage and information. The combination of high levels of leverage in financial institutions and informational imperfections provide a prudential rationale for financial sector regulation which is not relevant for non-financial sector businesses.

Many types of financial institutions are highly leveraged; their borrowings – their debt liabilities – are a multiple of their capital, in contrast to most non-financial sector businesses. The Ugandan business sector as a whole has equity and reserves which are almost as large as its debt liabilities.[1] In contrast, the Ugandan banking industry has debt liabilities (mainly deposits) which are almost five times larger than its equity and reserves. This means that if a bank fails, the consequences in terms of losses to its creditors are likely to be much greater than would be the case if a non-financial business were to fail. Furthermore, the creditors of a bank are mostly the general public who have deposited their savings in the bank, whereas the creditors of a non-financial business are mostly other types of businesses, including financial institutions. Hence the social consequences of a bank failure are much more serious than those of a non-financial business.

The pioneering research of economists such as Joseph Stiglitz into the economics of information has shown that financial markets are characterised by problems of information - what economists refer to as imperfect or asymmetric information – which prevent purely market determined outcomes being optimal for all participants in these markets. In essence, these problems arise because financial assets, such as loans, deposits and equity, are claims which will be realised at some point in the future, and the future is inherently uncertain. Therefore, the value of financial assets is also inherently uncertain.

[1] See the Uganda Business Inquiry, 2009/10, table 2.13, page 25.

However, information is not equally distributed among all market participants. The insiders who control financial institutions – their controlling shareholders and managers – usually have access to better information about the factors which will influence the value of financial assets than do the creditors, mainly depositors, of these institutions. As such, there is an informational asymmetry. Informational asymmetries also occur in equity markets; the owners and managers of firms which issue equity on stock markets have more information about the future financial prospects of their firm than do the investors who buy equity on the stock markets.

Asymmetric information offers opportunities for the owners and managers of financial institutions to exploit their informational advantage at the expense of their depositors. High leverage exacerbates the incentives on financial institutions to exploit informational asymmetries, because in highly leveraged financial institutions the upside rewards of high risk investment strategies accrue to the owners of these institutions, whereas the downside risk is borne by their creditors.

Consequently an unregulated financial system will contain incentives for excessive risk taking, at the expense of creditors such as depositors and of the stability of the financial system. This is not because the owners and managers of financial institutions are inherently crooked or incompetent, but because their interests are not aligned with those of the creditors of their institutions and because asymmetric information impedes the ability of the creditors to adequately safeguard their own interests.

It is this which provides the primary rationale for the regulation of the financial system by a public agency. This regulation is prudential in nature; it is intended to ensure that financial institutions are soundly manged and thereby to protect

their depositors, or other customers such as holders of insurance policies, and also to protect the overall stability of the financial system.

The regulatory framework in Uganda

Uganda has four separate financial sector regulators which each regulate and supervise a specific set of financial institutions or financial markets. These four regulators are the Bank of Uganda, the Insurance Regulatory Authority, the Capital Markets Authority and the Retirement Benefits Regulatory Authority which regulate, respectively, deposit taking financial institutions, insurance companies, the capital markets and the pension sector.

We have separate regulators rather than one single multi-sector financial regulator mainly because there are qualitative differences between the four main types of financial markets in terms of the objectives of regulation and especially with regard to the supervisory methodologies and techniques employed by the regulators. Consequently, there would be little to be gained by combining the regulation of, for example, banks and financial markets, within one single regulatory agency. This is the case in most countries, where banking regulation and supervision is separate from that pertaining to non-bank financial institutions and markets.

Each regulator in Uganda conducts its supervisory and regulatory operations according to the requirements of a specific piece of legislation. Deposits taking financial institutions are regulated under the Financial Institutions Act, 2004 and the Micro Deposit Taking Institutions Act, 2003; insurance companies are regulated under the Insurance Act, 2017; Capital markets are regulated under the Capital Markets Authority Act and its subsequent amendments; the pensions industry under the Retirement Benefits Regulatory Authority Act, 2011.

Hence all of the four financial sector regulators conduct their operations within a legal framework which has been legislated for by Parliament, and which sets out their statutory responsibilities, objectives and powers.

The primary objectives of each regulator depend on the characteristics of the financial market that they regulate. For example, the majority of the liabilities of banks are customer deposits. Banks also dominate the financial sector and perform crucial functions in the economy, such as transacting payments. Consequently the primary objectives of the bank regulator, the Bank of Uganda, is to safeguard the interests of depositors, so that they do not lose their savings as a result of reckless bank management or fraud, and to protect the overall stability of the banking system; i.e. to prevent a banking crisis which would be extremely disruptive for the economy.

In contrast to the banking system, the main participants in capital markets are wholesale investors which are relatively sophisticated in terms of their financial acumen; these investors consist mainly of financial institutions such as pension funds. Moreover, the capital markets are not large enough in Uganda to pose any systemic dangers to the wider economy. Consequently, the regulatory priority of the Capital Markets Authority is market conduct, so that all investors are treated fairly by issuers of securities and brokers and that they have accurate information on which to base their investment decisions.

Is the Financial Sector in Uganda Over-regulated?

I will now turn to the question posed in the title of this address; is the financial sector over-regulated? How should we attempt to answer such a question?
The approach that I will adopt is to acknowledge that bank regulation has costs as well as benefits for the economy, and that regulation is optimal, in the

economic sense of maximising welfare, when there is a balance between costs and benefits. The potential costs of regulation are that it might stifle growth and risk taking, especially lending to the private sector, whereas the benefits are soundly managed financial institutions which do not put their depositors funds at risk or jeopardise the overall stability of the financial system. I will concentrate on the regulation of the banking system for two reasons; first because it is more straightforward to identify indicators for the costs and benefits of regulation in banking than in other financial markets and second, because the banking industry is by far the most important component of the financial markets in Uganda, with commercial banks accounting for around 80 percent of the total assets of the financial system.

I will start by discussing the benefits of banking regulation. As I noted earlier, the primary objectives of banking regulation are to safeguard depositors' funds and to prevent a systemic financial crisis, so we should evaluate the benefits of regulation in terms of those objectives.

How does the bank regulator aim to safeguard depositors' funds? The BOU, in common with other bank regulators around the world, does not aim to prevent every single bank failure. In principle it would be possible to do this, by restricting banks to invest only in safe assets, but that would prevent banks from making one of their most important contributions to the economy, the extension of credit to the private sector. Extending credit is inherently risky, because not all borrowers will be able to repay their loans. Consequently, bank regulators accept that banks must incur some risk if they are to perform their proper functions, and that optimal bank regulation, therefore, cannot prevent all bank failures. Bank regulation aims to ensure that banks do not take excessive risks and also that they properly manage their risks, for example by adequate

diversification of their loan portfolio, so that bank failures are the exception rather than the norm.

One of the most important tools of bank regulation is the minimum capital adequacy requirement, which is based on the globally agreed approach set out in the Basel Capital Accords. Capital adequacy requirements stipulate that banks must hold a minimum amount of regulatory capital as a percent of their risk weighted assets. In Uganda, banks must hold total capital which is at least 12 percent of their risk weighted assets. The purpose of these capital adequacy requirements is to ensure that banks hold a buffer which can absorb losses and thus protect their deposits. If a bank suffers losses because of, for example, bad loans, these losses are first absorbed by the bank's capital. It is only if the losses exceed the bank's capital that the bank's depositors or other creditors will incur losses.

To safeguard depositors, the BOU is mandated under the Financial Institutions Act, 2004 to implement prompt corrective actions, which are triggered by a failure of a bank to comply with the capital adequacy regulations or by other indicators of financial distress. These prompt corrective actions are designed either to restore the bank to a sound financial condition, for example through recapitalisation by its owners, or if that is not possible, to trigger intervention by the BOU to resolve the failing bank in some way, for example by closure or by selling it to another bank, before significant losses to its deposits can occur.

What is the record of Uganda with respect to bank failures and losses of deposits? The current legal framework for bank regulation was put in place in 2004 when Parliament enacted the Financial Institutions Act, legislation which strengthened bank regulation following the bank failures that had occurred in the 1990s. Since the enactment of the Financial Institutions Act, 2004, there

have been three bank failures in Uganda: two very small banks in 2012 and 2014 and one larger one in 2016. The combined deposit market share of the three banks, at the time that each one was closed, was about seven percent. Because the BOU intervened in these banks in a prompt manner, in line with the mandatory prompt corrective actions stipulated in the Financial Institutions Act, depositors did not lose any of their money. In all three cases, the BOU was able to transfer the failed banks' deposits in full to other banks through Purchase of Assets and Assumption of Liabilities transactions, using the powers conferred on the BOU by the FIA. Had the BOU delayed its interventions in these failed banks, the losses which they incurred would have grown much larger and as a consequence it would have been much more difficult to ensure that depositors' funds were repaid in full.

Consequently, in terms of the objective of safeguarding depositors' funds, I think that it is fair to argue that bank regulation has been successful, in that bank failures have been few in number and that, when banks have failed; prompt regulatory intervention has protected their deposits from losses. In addition, given that the banks which failed collectively comprised less than 5 percent of the banking system's deposits, Uganda has not come close to suffering a systemic banking crisis. Hence the second strategic objective of the BOU's bank regulation, that of preventing a systemic financial crisis, has also been achieved.

Let me now turn to the potential costs of bank regulation. As I noted earlier, the more stringent are bank regulations, the more difficult it will be for banks to incur risks (i.e. by investing in risky assets) and this in turn will impede the growth of bank lending and stifle the overall dynamism of the banking system. Does the performance of the banking system since the enactment of the

Financial Institutions Act, 2004 offer any evidence that bank lending has been stifled by over regulation?

In September 2004, the total loans of the banking system amounted to 37 percent of its deposits. At that time the Ugandan banking system was still a relatively low intermediation banking system. Since 2004, however, rates of intermediation have risen markedly. In September 2017, the loan to deposit ratio was 64 percent. This ratio had been as high as 78 percent in 2011, during the credit boom of that year. Most of the increase in the banking system's rate of intermediation took place in the five years immediately following the enactment of the FIA, 2004, which does not suggest that the more stringent prudential regulations embodied in the FIA have impeded bank lending to the private sector.

Another approach to assessing whether regulation has impeded bank lending to the private sector is to ask whether specific regulatory provisions have been a binding constraint on lending. As a mentioned earlier, banks are required to hold a minimum amount of capital as a percent of their risk weighted assets. Loans are the main component of risk weighted assets, with a risk weighting of 100 percent. If a bank is only just able to comply with the minimum regulatory capital adequacy ratio, it cannot increase its holdings of risk weighted assets, for example, by expanding its loan portfolio, unless it also mobilises more capital. In such circumstances, the capital adequacy ratio will be a binding constraint on the growth of bank lending. Has this been the case in Uganda?

In the period since the enactment of the FIA, 2004, the statutory minimum requirement for banks' total capital has been 12 percent of their risk weighted assets. Over that period, the banking systems' actual levels of total capital averaged 18.8 percent of its risk weighted assets and it was never lower than

16.4 percent at any point during this period. Hence at the level of the banking system, which is what is relevant for lending to the overall economy, the capital adequacy requirement has not been a binding constraint to bank lending.

Of course, at the level of some individual banks, the statutory capital adequacy requirement has been a binding constraint on lending and other forms of risk taking in circumstances where banks have been suffering from financial distress. This is the purpose of the capital adequacy ratio; when banks are suffering financial distress, their risk taking must be curtailed to protect their deposits. As I discussed earlier, bank capital provided a buffer which helped to protect deposits in the three cases of bank failure which have occurred in recent years. Hence I would argue that our capital adequacy requirements have not curtailed bank lending at the aggregate level but have made an essential contribution to safeguarding depositors' funds in the few instances when banks have incurred financial distress.

Conclusion

Financial regulation in Uganda is based on well-established global principles, such as the Basel Core Principles for Effective Banking Regulation, and which have been incorporated into the legislation which governs regulation in the four main segments of the financial system; banks and other deposit taking institutions, insurance companies, pension funds and the capital markets.

There are sound economic reasons for subjecting the financial sector to greater regulation than other sectors of the economy, but I would argue that there is no compelling evidence to suggest that the banking sector is overregulated in Uganda.

No system of regulation is perfect, but the record of banking sector performance since 2004, when the current banking legislation was enacted, indicates that the primary objectives of bank regulation have been realised and that this has been achieved without significant negative impacts on lending growth and intermediation.

Thank you for listening.